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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1932

No. 412

LOS ANGELES GAS AND ELECTRIC CORPORATION,
Appellant,

vs.

RAILROAD COMMISSION OF THE STATE OF CALIFORNIA, et al.,
Appellees,

CITY OF LOS ANGELES,
Intervener.

BRIEF FOR APPELLEES.

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BRIEF FOR APPELLEES.

Appellees, the Railroad Commission of the State of California and the members thereof, will be referred to in this brief as the "Commission," and the appellant, Los Angeles Gas and Electric Corporation, will be referred to as the "Company."

Opinions of the Court Below and of the Commission.

The opinion of the District Court of the United States for the Southern District of California on final hearing is reported in *Los Angeles Gas and Electric Corporation v. Railroad Commission of the State of California, et al. (City of Los Angeles, Intervener)* (April 8, 1932), 58 Fed. (2d) 256, and is included in the record herein at pages 106-178. The final decree dismissing the bill of complaint, dated May 3, 1932, is included in the record at pages 203-204.

There was no opinion of the Court below on the motion for interlocutory injunction. The interlocutory injunction is printed in the record at pages 101-103.

The opinion and order of the Commission, the validity of which was upheld by the District Court in its opinion and decree above mentioned, are reported *"In the matter of the Investigation upon the Commission's own motion into the rates, etc., of Los Angeles Gas and Electric Corporation,"* November 24, 1930, 35 C. R. C. 442, and are included in the record herein at pages 17-66, inclusive.

Statement of the Case.

This appeal is from a decree of the District Court of the United States for the Southern District of California dismissing appellant's bill of complaint praying for a permanent injunction restraining the enforcement of a rate fixing order made by the Commission.

The Commission, by an order issued November 24, 1930, directed appellant to reduce its rates for domestic and

commercial gas service by approximately 9 per cent beginning January 1, 1931.[1] (R. 54.) Thereafter, on December 22, 1930, the Company filed a complaint praying for both a temporary and permanent injunction to restrain the enforcement of said order. It was contended that the order was arbitrary and the rates fixed were confiscatory, depriving the Company of its property without due process of law in violation of the 14th Amendment to the Constitution. The statutory three judge Court[2] on January 8, 1931, and upon a bond being filed by appellant, issued its temporary injunction. (R. 101.) Under the bond the Company obligated itself to return to the consumers sums collected in excess of the rates prescribed in the Commission order in the event said order was ultimately upheld. (R. 103.) By stipulation of counsel the matter was submitted for decision on the merits upon the pleadings and affidavits on file and the complete record made in the proceeding before the Commission. (R. 104-106.) In conformity with its opinions filed April 8, 1932 (R. 106-118; 119-178) the Court on May 3, 1932, entered a decree dismissing the complaint. (R. 203.) The decree directed that refunds be made to consumers of all charges collected in excess of those fixed by the Commission with the provision, however, that enforcement of the said decree would be stayed if an appeal to this Court were perfected within thirty days and upon the furnishing of a further bond. (R. 204.) The order

1. Only the gas rates of the Company are here involved and all statements, unless otherwise noted, apply exclusively to its gas business.

2. The Court was constituted in compliance with Judicial Code 266, 28 U. S. C. Sec. 380 and was comprised of Circuit Judge Wilbur, and District Judges James and Jacobs.

granting a stay pending appeal was filed May 18, 1932. (R. 205.)

The Company, pursuant to the interlocutory injunction, has continued to collect the existing rates and now has on hand the difference between the existing rates and the reduced rates prescribed by the Commission.

THE PROCEEDING BEFORE THE COMMISSION.

Since 1914 the Commission has been possessed of regulatory jurisdiction over the rates of the appellant, and in a series of rate cases beginning in 1915 it has from time to time increased or decreased the Company's rates. (R. 21.) Since 1913 the Company has been obligated to file with the Commission an annual report and comply with the Uniform Classification of Accounts prescribed by the Commission. (R. 471.)

The gas rates which appellant seeks to have declared confiscatory of its property were prescribed in an order issued November 24, 1930, as a result of a formal investigation instituted by the Commission upon its own motion into the rates of the Company. (R. 222.)[3]

The record made before the Commission was exhaustive and covered every subject customarily considered in a

3. The Railroad Commission of California was created by the Constitution of the State, Article XII, Sections 22 and 23, and under said provisions and under the Public Utilities Act of California it is vested with general jurisdiction over the rates, accounting practices, etc., of appellant Company. The Commission by an investigation on its own motion may order an increase or a decrease in rates. Sections 31, 32a, 32b, 53, 60 and 61 of the Public Utilities Act of California; California Statutes 1915, p. 115; 1923, p. 837; *Saunby v. Railroad Commission* (1913), 191 Cal. 226.

complete rate case, such as valuation, revenues and expenses, rate of return, etc. In all, twenty-four days were occupied in the presentation of evidence. The transcript of testimony comprised 2,130 pages, and sixty-seven exhibits were received, many of which represented exhaustive engineering studies. (R. 18.) Accompanying its order fixing the gas rates which the Company might charge after January 1, 1931, the Commission rendered an opinion in which it discussed every feature of the case. Its opinion is exhaustive and findings complete upon all material issues. (R. 17-58.)

THE PROCEEDING BEFORE THE COURT.

The entire record made before the Commission was offered and received in evidence before the lower Court. The Commission record, the pleadings and the affidavits filed by the parties in support of and in opposition to a motion for interlocutory injunction constituted the record before the Court. (R. 107.) The issues were briefed and the case submitted on the merits on June 2, 1931. Two opinions were filed in the matter on April 8, 1932. Judge James filed the majority opinion, which was concurred in by Judge Jacobs (R. 106-118), and Circuit Judge Wilbur filed a separate concurring opinion. (R. 119-178). All the judges concurred in the view that the Commission order was lawful and that the requested relief should be denied. With reference to the occasion for filing a separate opinion Judge Wilbur stated:

> "I find myself in concurrence in the main with the reasoning and conclusions of Judge James, and particularly in his conclusions as to the fair rate and

> rate base. I have, however, thought fit to express my views on going concern value, accrued depreciation and depreciation annuity more at length, as I find the subject particularly difficult. The injunction should be denied." (R. 178.)

The opinions of the Court were prepared with studied care and contain findings on every material issue presented by the pleadings.

By way of summary the Court in its final decree found as follows:

> "The court now finds that the values for plaintiff's property as fixed and determined by the defendant Railroad Commission are the reasonable values thereof; that the rates fixed are such as to render a reasonable return on such values and that said rates are therefore not confiscatory. And the court adopts, as representing its further findings, the opinion filed herein on April 8, 1932, as concurred in by the two district judges who participated in the hearing and decision hereof." (R. 204.)

Circuit Judge Wilbur, in concurring in the decree, added:

> "I concur in the decree and for findings of fact upon the issues refer to my concurring opinion as the findings of fact upon which I base this decree." (R. 204.)

WHAT THE COMMISSION DID IN ITS DECISION.

The Commission tested the rates ordered to become effective January 1, 1931, by applying them to normal expected sales in 1930, and by the application of the expected net revenues thereunder to two bases of value

which were found to represent the average capital for that year. The results found may be summarized from the tables presented in its decision, as follows:

OPERATING RESULTS.
(R. 26,45, 47.)

	Under Existing Rates 1930		Under Rates Prescribed 1930	
	Historical Cost	Fair Value	Historical Cost	Fair Value
Revenues	$16,415,000	$16,415,000	$15,003,000	$15,003,000
Expenses	10,558,000	10,630,000	10,315,000	10,388,000
Net Return	5,857,000	5,785,000	4,688,000	4,615,000
Rate Base	60,704,000	65,500,000	60,704,000	65,500,000
Rate of Return	9.6%	8.8%	7.7%	7%

The Commission thus used two tests of value, one based upon the investment of the Company in its gas property, and the other based upon a finding of its present fair value. Neither base was decreased by the amount of accrued depreciation. The Commission manifested a preference for the fixation of rates on the actual investment basis with lands at present market value (R. 19), but recognized that the decisions of this Court require that rates be fixed to allow the utility an earning of a fair return upon the fair value of its property. (R. 36-54, particularly R. 43.)

No declaration made by the Commission in its opinion may be taken as an admission that it fixed rates in this case upon the basis of historical cost alone, or as evidence that it refused to acknowledge obedience to the law of the land in respect to the valuation of utility properties for rate purposes. It will presently be shown that the Commission's finding of fair value was made only after full consideration given to all evidence, and the exercise

of a reasonable judgment in compliance with what it interprets to be the opinion of this Court. It may not be inferred that because it found a historical rate base as well as a present value base, it failed to give due weight to all evidence in respect to the present fair value of the property. The Commission has frequently expressed its preference for the adoption of historical cost, other than for land, as a basis for the valuation of the utility's property, and even in the face of recent price declines to a point in many cases greatly below actual cost, it has continued to affirm its preference for a rate-making principle which first of all will protect the utility in its actual investment. At least three-fourths of the Company's actual investment has been made within the decade preceding the valuations in this record, a period of uniformly high prices. The record shows that on January 1, 1930, a downward trend in prices had become apparent, and subsequently during the course of the proceeding before the Commission and before the Court the decline in construction costs was precipitous.

The Commission did not adopt any artificial rule or formula. Its opinion clearly shows that it considered and weighed all factors properly to be given consideration. It declared merely that as to current costs, when readily ascertainable, it accorded a dominant consideration. In so far as the various elements of value can be reduced to definite figures, and one or another element accorded particular weight, the regulatory body may properly adopt some guide in order that uniformity of regulation may be obtained.

The occasion for the Commission's refusal to diminish its estimate of value for existing and accrued deprecia-

tion will presently be explained. From evidence contained in the record it might have done so, and had it adopted an annual depreciation expense commensurate with a depreciated rate base, the anticipated earning result would not have been appreciably altered.

THE ALLEGED ERRORS.

Briefly stated, the points urged by appellant in its appeal are (1) that the value of the property was understated by the Commission and the lower Court; (2) that revenues were over-estimated; (3) that expenses were under-estimated; (4) that the rate of return allowed was below the level of a fair return, and (5) that the lower Court failed to exercise an independent judgment on the law and the facts.

With reference to valuation, it is contended by appellant that neither the Commission nor the Court below gave consideration or weight to going concern value, historical cost or cost of reproduction new of the Company's property in arriving at its estimate of fair value, and that its determination of fair value was arrived at by the application of an erroneous formula.

Concerning revenues the appellant argues that the Commission's estimate, predicated upon normal temperature conditions, was erroneous and resulted in over-estimating the revenues reasonably to be expected.

Under the heading of "Operating Expenses," only two items are questioned, the refusal of the Commission to allow as an operating expense an annual payment of $80,000 to its holding company for alleged services, and

the Commission's determination of a reasonable allowance for depreciation annuity.

On rate of return it is contended that the return allowed is confiscatory and below that enjoyed by other undertakings with comparable risks and uncertainties doing business in the locality.

On the subject of the gas manufacturing plants, it is urged that the Commission and the lower Court were in error in holding that the very doubtful usefulness of said facilities had an appreciable adverse bearing on their value.

It is also suggested in the brief of appellant that the lower Court, in upholding the order of the Commission, failed to exercise an independent judgment on the law and the facts.

In our argument herein the several points urged by the appellant will be answered in the order presented, except that the judgment of the lower Court will be discussed at the outset and the treatment of the artificial gas manufacturing plants will be dealt with under the heading of "Value of the Property" rather than as an independent subject as treated by appellant.

CORRECTIONS OF APPELLANT'S STATEMENT OF THE CASE.

Under the rules of this Court it is incumbent upon appellant to set forth in its brief a concise statement of the case. In the brief filed herein by appellant that statement is highly argumentative and is not concise. (Appellant's Brief, pp. 5 to 34.)

At this point, under our correction of appellant's statement of the case, we will not undertake to correct the argumentative material, but will only point out certain statements of fact which we believe to be erroneous.

(1) At page 5 it is stated that the Commission in past rate cases has invariably adhered to a certain formula and fixed rates upon the historical cost of property, taking land, however, at current values and depreciation calculated on a sinking fund basis to yield a return somewhat in excess of the cost of money invested in the property. Although this statement is substantially accurate, it should not be inferred therefrom that the Commission has been unmindful of the rule of this Court announced in *Smyth v. Ames,* and other decisions of this Court with reference to rate making. As will presently appear from the argument to follow, the Commission in the instant case fully met the requirements of *Smyth v. Ames* and fixed rates to yield a fair return on the fair value of appellant's property.

(2) At page 6 of its brief, in an apparent effort to inject into this case a prejudicial atmosphere favorable to the appellant, it is stated that the Commission itself recognizes that its past practice of rate making is opposed to the decisions of this Court, and reference is made to a statement contained in an address given by a member of the California Commission before a convention of public utility commissioners. What might have been said on such an occasion cannot be taken to represent the views of the Commission, and certainly cannot have the remotest bearing on the merits of this appeal. In fairness to the commissioner, counsel for the appellant should have

quoted the whole of the paragraph from which the quoted sentence was lifted.[4]

(3) At pages 9, 10 and 12 it is stated that the Commission failed to consider certain evidence, notably evidence as to elements of value, the current depreciation and the decline in the cost of service to the consumer. These matters were not ignored, but, as will presently appear, were carefully and properly considered along with all other evidence of record.

(4) At page 9 it is stated that the Commission prescribed rates for the future solely from a consideration of "adjusted" operating results of 1928-1930. This is not the fact, as will appear under the discussion of revenues and return which follows herein.

(5) At page 17 it is stated that throughout the winter season the generators of its gas plants are heated and in readiness to supply any deficiency in natural gas that might arise. The record shows that during the winters of 1928-1929 and 1929-1930 only plant No. 3 was heated. Plants Nos. 1 and 2, representing three-fifths of the total plant capacity, were not heated during said period (R.

4. "It is safe to say that in practically none, if any of the cases in which there have been permanent injunctive orders issued by the Federal Courts, would actual confiscation have followed the Commission findings. This is stated not only from general knowledge of the facts but from specific knowledge of the experience in California. A study of the Court opinions indicates beyond reasonable doubt that in practically every major rate case in the last seventeen years in that state the findings of the Commission could not have withstood the test imposed by the federal tribunals. And yet we find the affected utilities able adequately to finance, operating at relatively low rates, and giving good service. The same thing undoubtedly may be said of other states." (Proceedings National Association of Railroad and Utilities Commissioners 1931, p. 190.)

469), and during the period of three years and eight months subsequent to April 11, 1927, only 569,000 cubic feet of gas has been manufactured in all plants, which amount was manufactured on March 13, 1928, and constituted nine-tenths of one per cent of the total gas send-out of that date.

(6) At pages 21 and 22 it is stated that the Commission did not fix the rates on the basis of a fair return on the fair value of the property of the appellant, but adhered to a fixed formula. This is not the fact and, as appears from the face of the Commission decision, the rates were fixed on a fair value basis without adherence to any formula. (R. 43-50.)

(7) At page 22 it is stated that the Commission admits in its answer that the fair value rate base was determined by taking a reproduction cost estimate using one-day unit prices as of June 15, 1930, with overheads at 6.35 per cent, plus land values used in the historical rate base. Reference is made to R. 91 for this alleged admission. The statement is in error. The Commission at said page of the record denies that the fair value rate base is so determined and alleges the same to be a judgment figure arrived at after consideration of the entire record, including all costs and estimates of value. The Commission, however, admits that a dominant consideration was given to the current price level cost in arriving at its fair value, which will be presently explained.

(8) At page 22 it is stated that no allowance was made for going value. Although no finding was made as to the amount of going value, the said element was recognized

by the Commission in the rate bases and return allowed thereon, as will appear in the argument to follow.

(9) In other particulars the appellant in its statement of the case (pp. 5-34) charges that the Commission was arbitrary in its methods and that the opinions of the Commission and the Court are erroneous in various respects. Without particularizing further, these statements are denied and will be dealt with later in the brief under appropriate headings.

Summary of Argument.

It will be our purpose to point out, under appropriate headings, (1) the lower Court exercised an independent judgment; (2) value of the property; (3) revenues; (4) operating expenses, and (5) rate of return, that the lower Court thoroughly reviewed the record and exercised an independent judgment on the law and the facts, and that the Commission order was properly upheld. We will demonstrate that the rates were fixed by the Commission to yield a fair return on the fair value of the Company property in accordance with the law of the land and that the estimates of value, revenues, expenses and return were reasonable and supported by the record. A summary of the argument in the order in which the questions will be discussed follows:

(1) *The Lower Court Exercised an Independent Judgment.* Under this heading of our brief reference will be made to the two opinions of the lower court, demonstrating that the entire record was carefully reviewed and an independent judgment on the law and the facts accorded by the Court.

(2) *Value of Property.* Under this title we will undertake briefly to review the evidence before the Commission and the Court on valuation, particularly historical cost, reproduction cost new, reproduction cost new less depreciation, the gas manufacturing plant and its very doubtful usefulness, the so-called current price level cost estimates, and going concern value, and will demonstrate that all of such evidence was carefully weighed in arriving at a determination of *fair value.* We will undertake to show that the fair value determination represents a judgment figure which is reasonable and meets with the requirements of *Smyth v. Ames,* 169 U. S. 466, and subsequent decisions of this Court.

(3) *Revenues.* Under this heading we will show that the estimate of gross revenues used by the Commission in its decision is predicated upon the estimate of gas sales made by the Company's own engineer, and that the normal temperature basis (22-year average) used in estimating sales is reasonable and has been used in prior rate cases affecting this Company.

(4) *Operating Expenses.* In this subdivision of our brief we will demonstrate that the Commission was warranted in not including in operating expenses the holding company fee (Pacific Lighting Fee) and that the depreciation allowance used by the Commission and approved by the Court was ample and proper.

(5) *Rate of Return.* Under this title it will be shown that the rate of return was reasonable and in fact liberal to the Company.

Argument.

I. LOWER COURT EXERCISED INDEPENDENT JUDGMENT ON THE LAW AND FACTS.

Although appellant places no particular emphasis upon the point, it is suggested throughout its brief that the lower Court failed to exercise an independent judgment on the law and the facts. An examination of the two carefully prepared opinions of the lower Court demonstrates that this point is wholly without merit. In the majority opinion of the Court it was said:

> "A careful study of the record has been a task entailing considerable labor, but the conclusions resulting need not, in the statement of them, be of proportionate length. It has not been thought of helpful use to analyze in any detail the great mass of evidence, nor to particularly refer to the authorities cited in the elaborate argument presented.
> (R. 109.)

Then followed a detailed and careful consideration of the various issues before the Court.

Circuit Judge Wilbur also recognized that the Court was obligated to exercise an independent judgment on the law and the facts (R. 119-122) and proceeded with meticulous care to set forth at length his views on all material issues.

The two opinions conclusively show that there was no failure on the part of the Court to carefully consider the evidence or to exercise an independent judgment on the law and the facts.

II. VALUE OF THE PROPERTY.

THE LAW APPLICABLE TO VALUATION.

In determining the fair value of the Company's property, the Commission was confronted with the duty of considering, among other matters, "the present as compared with the original cost of construction." In the early case of *Smyth v. Ames* (1908) 169 U. S. 466, 547, the various elements of value to be considered in rate making were enumerated:

> "We hold, however, that the basis of all calculations as to the reasonableness of rates to be charged by a corporation maintaining a highway under legislative sanction must be the fair value of the property being used by it for the convenience of the public. And, in order to ascertain that value, the original cost of construction, the amount expended in permanent improvements, the amount and market value of its bonds and stock, the present as compared with the original cost of construction, the probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses, are all matters for consideration and are to be given such weight as may be just and right in each case. We do not say that there may not be other matters to be regarded in estimating the value of the property."

The foregoing rule has been consistently adhered to by this Court. *St. Louis & O'Fallon R. Co. v. United States* (1929) 279 U. S. 461, 484. It is well established that valuation is not to be controlled by rules or formulas, but is to be arrived at by the exercise of a reasonable judgment based upon a proper consideration of all relevant facts. *Minnesota Rate Cases* (1913) 230 U. S.

352, 434. With reference to the exercise of judgment this Court said in the case of *McCardle v. Indianapolis Water Co.* (1926) 272 U. S. 400, 410:

> "The decision of this court in *Smyth v. Ames,* 169 U. S. 466, 547, declares that to ascertain value 'the present as compared with the original cost of construction' is, among other things, matters for consideration. *But this does not mean that the original cost or the present cost or some figure arbitrarily chosen between these two is to be taken as the measure. The weight to be given to such cost figures and other items or classes of evidence is to be determined in the light of the facts of the case in hand.*"[5]

It is equally well established by this Court that reproduction cost new is not tantamount to value. This was recognized in *Georgia Rwy. v. Railroad Commission* (1923) 262 U. S. 625, 630, wherein it was stated:

> "The refusal of the commission and of the lower court to hold that, for rate making purposes, the physical properties of a utility must be valued at the replacement cost, less depreciation, was clearly correct."

Again, in the case of *McCardle v. Indianapolis Water Co.* (1926) 272 U. S. 400, 423, Mr. Justice Brandeis in his disssenting opinion states:

> "There is, so far as I recall, no statement of this court that value is tantamount to reproduction cost."

Mr. Justice Stone in his dissenting opinion in *St. Louis & O'Fallon Rwy. v. United States* (1920) 279 U. S. 461, 551, likewise observed:

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5. Italics used throughout this brief are supplied by the writers unless otherwise indicated.

> "This court has said that present reproduction costs must be considered in ascertaining value for rate-making purposes. But it has not said that such evidence, when fairly considered, may not be outweighed by other considerations affecting value, or that any evidence of present reproduction costs, when compared with all the other factors affecting value, must be given a weight to which it is not entitled in the judgment of the tribunal 'informed by experience' and 'appointed by law' to deal with the very problem now presented."

Among the facts to be considered in determining value is the actual practical history of the enterprise as developed by the evidence. *Galveston E. Co. v. Galveston,* (1922) 258 U. S. 388; *Georgia Rwy. & Power Co. v. Railroad Commission,* (1923) 262 U. S. 625.

We will now discuss, under appropriate headings, the evidence as to various elements of value and demonstrate that they were fairly considered and that the result is in conformity with the foregoing principles.

THE COMMISSION FIXED BOTH FAIR VALUE AND HISTORICAL COST RATE BASES.

In fixing the rates of the Company the Commission fixed two rate bases: (1) representing the historical cost of the property, and (2) representing the fair value of the property. The historical cost figure, representing average capital for 1930, was $60,704,000 (R. 27.), while the fair value figure for 1930 was $65,500,000. (R. 47.) Both figures are undepreciated. The return to the Company reasonably to be anticipated, as found by the Commission, was 7.7 per cent and 7 per cent on the respective bases (R. 47.)

Why did the Commission in its approach test the rates prescribed on a historical cost base as well as a fair value base? The answer is found in the fact that the California Commission has preferred to fix rates on the historical cost basis, and in practice has found it to be a fair and practical method to follow. As stated in the Commission opinion (R. 19-21):

> "This Commission for many years, in the exercise of its jurisdiction to establish reasonable rates for utilities of this character, has fixed rates to yield upon the historical or actual cost of the property, taking land, however, at current values and depreciation calculated on a sinking fund basis, a return somewhat in excess of the cost of the money invested in the property. Where the books were accurately kept these have been deemed to most accurately reflect the actual cost of the structural and other property. Sometimes, when these were not reliable, it has been found necessary to estimate what it cost to produce the whole or parts of the property historically.
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> * * * * * * *
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> "Under rates fixed on this basis utilities of this character have grown strong and prosperous. They have experienced no difficulty in securing capital for extensions and new development. Confidence in investments in such utilities has increased and capital has flowed to this field of investment readily and at a gradually decreasing rate or cost.
>
> The Los Angeles Gas & Electric Corporation in respect to its gas operations has been before this Commission frequently since the time the Commission was given jurisdiction over its rates, sometimes on its application for authority to increase its rates, sometimes at the instance of the Commission or of

complainants looking to reduction of rates. In all of these various proceedings rates were tested or measured by the standard stated above. Its rate base for its gas department has grown from approximately $12,500,000 in 1916 to nearly $59,000,000 in 1929, and its independent active meters from 131,500 to 351,000 during the same period.

The growth in its gas department has been even exceeded by that in its electrical department, its rate base in that having increased from approximately $6,000,000 in 1916 to over $41,000,000 in 1929. The Company's total invested capital during the past fifteen years has increased to a sum more than five times the amount at the beginning of that period."

The fact that the California Commission in the past has manifested a preference for the use of the historical cost method of rate making does not mean that the Commission has been unmindful of the majority opinions of this Court holding that utilities are entitled to earn a fair return on the fair value of their property.[6] Certainly in the fixing of rates for appellant the Commission, in the order now under attack, endeavored with studied care to fix rates on a fair value basis to yield a reasonable return. This fact, we believe, will presently be apparent.

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6. That the California Commission has followed a reasonable policy in the fixing of utility rates is borne out by the fact that only one of its rate orders has been held confiscatory by the Courts (both State and Federal) in twenty years of regulation. *Los Angeles Railway Co. v. Railroad Commission*, 29 Fed. (2d) 140, affirmed in 280 U. S. 145.

HISTORICAL COST.

The historical rate base of $60,704,000 used by the Commission as representing the Company's actual investment, with land at present value, is set forth in its opinion by property accounts. (R. 27.)[7] The basis accepted for determining that value was explained by the Commission as follows:

> "Estimates of the historical cost of the structural property were made in this proceeding, both by the Company and by the Commission's Valuation Department. Excluding overheads, the Company reached a figure approximately $300,000 higher than the one obtained by taking the 1917 rate base as fixed by the Commission in its first decision and building up on that, while the Valuation Department of the Commission reached a figure approximately $300,000 lower than the one thus obtained. The fact that each of these estimates, independently reached by employing somewhat different methods and procedure, corresponded so closely to the historical cost figure as used and accepted by the Commission and by the Company as correct in the series of rate determinations running from 1917 to 1928, confirms its substantial accuracy. The figure used conforms to the accounting practice of the Company as to the bulk of its investment, which has increased from approximately $13,000,000 in 1917 to over $58,000,000 in 1929, the difference representing net additions and

7. The Commission's decision in 1917 is reported in 13 C. R. C. 724. The rate base was founded upon a valuation made by the Commission's engineers as of October 1, 1915, termed "Reproduction Cost New", although it was conceded by the Commission's engineer Wehe in this case that the costs used were probably the same as historical costs of that date. (R. 303.) Indirect overheads were estimated at 13.09 per cent. (R. 299.)

betterments during this period as inscribed in the Company's books and records."
(R. 27, 28.)

The Commission thus accepted the actual recorded cost of all property added since July 1, 1917, at which date the Company's total gas property was valued by the Commission at $12,946,639.[8] Since that valuation was made, all additions and betterments are accurately recorded. In each rate proceeding subsequent to that valuation, the base then accepted has been taken by both the Company and Commission engineers as a basis for the determination of the actual cost of the property. (R. 29, 358.)

The Company now contends that the historical cost base used by the Commission is deficient by not less than $2,177,765. The disputed difference is due simply to claimed indirect construction costs which engineers for both the Company and the Commission testified might, in estimating the historical cost, reasonably have been included as capital charges.

To the respective original cost estimates for the structural properties alone, which the Commission showed were almost identical with the recorded cost (R. 27-28), both engineers, in reconstructing the property historically, estimated that from 11.25 to 14.48 per cent should be

8. The base figure of $60,704,000 was made up of $58,842,187, representing total fixed capital as of December 31, 1929, plus $1,862,103 representing working cash, material and supplies and average net additions and betterments for 1930. (R. 27.)

added to the base cost for indirect charges, or overheads.[9] The average overheads actually charged by the Company to its capital accounts from 1913 to 1929, inclusive, expressed as a percentage of the base cost of all plant additions, is approximately 6 per cent. (R. 272.) The Company claims, therefore, that its capital accounts as recorded are understated by not less than $2,177,765, and that the Commission's historical rate base is deficient by that amount.

It is submitted that the acceptance by the Commission of actual recorded costs for nearly the whole of the Company's property and an admittedly fair appraisal for that minor portion constructed before the Commission first obtained jurisdiction over this utility, was not arbitrary or unreasonable. On the contrary it was a true appraisement of the actual invested capital in the property.

This item of overheads which is in dispute does not represent an expenditure of capital which has not been accounted for under any of the Company's accounting heads. It represents merely what was once deemed by it to be a proper operating expense, and so entered year by year, and now, under its claim, may be withdrawn from past expense allowances and used to augment its capital account. The nature of these changes requires brief explanation.

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9. The Company's estimate of historical reproduction cost, with overheads of 14.48 per cent included, amounted to $63,413,246 as of January 1, 1930 (R. 366), while the Commission engineer's estimate, including overheads of 11.25 per cent, totalled $61,019,662 as of December 31, 1929. (R. 252.)

Historical Overheads.

Overheads are the indirect costs incurred through such general expenditures as those for engineering services, superintendence, interest and taxes during construction, injuries and damages, legal expense, and for miscellaneous omissions and contingencies. Obviously such indirect costs in some amount are normally incurred. If they are to be estimated, their amount is a matter of judgment. But the costs therefor actually incurred may be recorded and ascertained just as accurately as the direct costs incurred in the construction of the various property units. The Company's records show all such costs, and show the exact proportion which annually has been deemed properly allocated to capital or included as an annual operating expense.[10]

The Company's property has been constructed in units over a period of many years. Some new construction has been undertaken by its own engineering and construction forces, and some let to private contractors. The same officials, engineering, accounting and legal forces which have supervised new construction, have at the same time

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10. Effective January 1, 1913, the Commission promulgated a uniform system of accounts, which system (with some unimportant changes) has been applicable to appellant corporation at all times since said date. Under the accounting rules so prescribed, the term "cost" as used in the texts for fixed capital accounts was defined to mean *original* cost to the corporation, including all overhead costs. (R. 475.) Under the uniform system of accounts as it now reads, it is provided:

> "So far as possible overhead construction costs, such as engineering costs, law expenses, injuries and damages, taxes and interest during construction, shall be assigned or apportioned to particular accounts, to the end that each item of property shall bear its proper share of such cost and that the entire cost of the item of property, both direct and overhead, may be deducted from the fixed capital accounts at the time the item of property is retired." (R. 475.)

attended to similar duties in the course of maintaining and operating the property.

The total cost of maintaining an executive and engineering personnel is, therefore, only partly assigned as a capital charge under the title of construction overheads. Of necessity it must be apportioned somewhat arbitrarily between operating expense and capital. Accounting rules prescribed by the Commission necessarily permit the utility to exercise a reasonable judgment in this respect. (R. 475.) In accordance with such rules the Company has each year determined upon a reasonable basis of allocation for these charges.[11] Its method has not been to add to capital any fixed percentage of the base construction cost of each unit added during the year, but on the contrary it has determined each year the reasonable proportions in which all such expenditures should be assigned either to capital or to operation. The actual amounts so allocated to capital have varied greatly and bear no fixed relation to the base construction costs. In percentages the amounts assigned to capital each year since 1913 vary from 1.39 per cent to 12.57 per cent. (R. 272.) With one exception, in the case of interest during construction and for which the Commission made special allowance (R. 27) all such management, engi-

11. The record shows that the books of the Company were exceptionally well kept, one of the witnesses testifying:

> "We are fortunate in this case in having the records of the Company available, which are the most complete and reliable I have ever examined. The method of allocation used by the Company in the past has been largely a matter of judgment and the percentages of various accounts charged to capital and operation have varied considerably. From time to time the Company officials look over the relative amounts of operation and construction and arrive at a certain split between the two." (R. 277-278.)

neering, legal and other expenditures actually made and not actually prorated to its capital accounts have been accounted for in annual expenses of operation. (R. 268, 358, 369, 468.)

The Company contends that such indirect construction costs now estimated reasonably to have been incurred, although at the time incurred deemed chargeable in greater part to its annual expense of operation, are as much a part of the true cost of its property as the bricks and iron in its physical structures. It is submitted that for the purposes of valuation in a rate proceeding for a utility subject to continuous regulation, this is not true. The source accounts from which such overheads flow are not those in which are entered the actual cost of the various units of the physical property at the time acquired. They are accounts, rather, which record expenditures necessarily annually incurred in large part regardless of the new construction undertaken.[12] When, at the election of the Company's officers, such charges are annually included in expenses of operation and are so accounted for in its annual reports to the Commission and in proceedings to fix its rates, their withdrawal now from that account and their inclusion in capital results directly in a duplication of charges.[13]

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12. In recent years during which new construction has not kept pace with previous years (R. 24) the amounts allocated to capital bear a considerably higher percentage relation to new construction costs. (R. 272.)

13. The record shows that all overhead costs not charged to capital were in fact charged to operation (Company witness Masser, R. 358; Commission witness Wehe, R. 268, 468) and that in prior rate cases the Company reported its overheads as they appeared on the books. (R. 358.) The annual capital additions and operating expenses reported to the Commission in sworn annual reports have reflected total figures arrived at on the basis of the overhead allocations as made by the Company.

In a number of the past rate cases increases in rates were granted. (R. 21.) If the amount charged to operation had been decreased and the amount charged to capital increased, the net revenue would have been correspondingly augmented. It cannot be assumed that the Commission would have granted increases in rates as was done if overheads had been divided between operation and capital in a manner different than that actually followed.

As was properly pointed out by Judge Wilbur in his concurring opinion, the problem presented is largely one of accounting practice. (R. 128-134.) This utility has been under continuous regulation and subject to prescribed accounting rules. The very object of such a system of accounts is to keep capital costs and operating costs distinct. (R. 130-131.) The lower Court, in both opinions, found that the action of the Commission was reasonable in accepting the book figures in arriving at its historical cost rate base. (R. 114, 142, 171.)

Authorities on Overheads.

In the valuable work by Whitten-Wilcox on "Valuation of Public Utilities" (2nd Edition at pp. 559-562) there is quoted portions of the report made by a committee of the American Association of Civil Engineers on the treatment of overhead charges in valuations of public utility properties. That committee, after making its recommendations for the allowance in a historical valuation study of overheads reasonably incurred, made this pertinent observation:

> "The statements in the last paragraph may invite the criticism that, if the method of bookkeeping is

such that a part of the overhead charges for additions to the property has been placed in operating expenses, it has been paid for by the public and not by the company, and hence should not appear in a valuation of the property. In this matter the Committee makes a distinction between valuation and regulation, and takes the ground that in valuation the total cost of the property should be included, regardless of past methods of bookkeeping. It recognizes, however, that in continuous regulation, including the control of rates by a public service commission, there should be no duplications by charging items to both the capital and the expense accounts."

In the same work, at page 1017, the authors say:

"One of the chief functions of accounting is to keep capital costs and operating costs properly separated. When a standard system of accounts approved or prescribed by a public authority has been adopted by a utility, it becomes in practice the joint function of the utility's engineers and accountants to distribute construction, maintenance and operating costs according to the rules laid down. In doing so they have to exercise practical judgment enlightened by knowledge of actual facts as they develop in the experience of the utility. It seems unthinkable that the regulating authorities in the first instance, and the courts ultimately, should prescribe and enforce a system of accounting by which capital costs and operating charges are meticulously separated on the utility's books, and later on, in making valuations for rate purposes, ignore the classification of expenditures so prescribed, or resort to some other, different and inconsistent classification and distribution of expenditures. Any tendency to divorce valuation from established methods of accounting and throw ap-

praisers entirely upon their own resources, without support from the utility's records of actual performance, obviously is wasteful of experience, multiplies confusion, induces paralysis of the regulatory function, and exalts the importance of 'that most unsatisfactory evidence, the testimony of expert witnesses employed by the parties.' (Knoxville v. Knoxville Water Company, 212 U. S. 1, 18.)"

This Court also has recognized the necessity in the regulation of utilities of maintaining a clear distinction between capital and expense. Accounting rules of the Interstate Commerce Commission prescribed for rail carriers were upheld by the Supreme Court in *Kansas City Southern Ry. v. United States* (1913), 231 U. S. 423. The importance of prescribed accounting methods to successful regulation cannot be more clearly expressed than by the language which the Court used in that case, pages 440, 445:

"The very object of a system of accounts is to display the pertinent financial operations of the company, and throw light upon its present condition. If they are to truly do this, the form must correspond with the substance. In order that accounts may be standardized, it is necessary that the accounts of the several carriers shall be arranged under like headings or titles; and it is obviously essential that charges and credits shall be allocated under the proper headings,—the same with one carrier as with another.

* * * * * * *

"Since the regulation of the railroad carrier by the public authority, and especially the fixing of the rates to be charged, depend primarily upon two fundamental considerations, (a) the value of the prop-

> erty that is employed in the public service, and (b) the current cost of carrying on that service, it is clear that the maintenance of a proper line of distinction between property accounts and operating accounts is essential to the execution by the Interstate Commerce Commission of the supervisory and regulatory powers conferred upon it by Congress."

It is true that a regulatory body may not appropriate a utility's reserves or earnings which actually belong to the utility. Such was the attempt of the regulatory Commission in *Board of Public Utility Commissioners v. New York Telephone Co.*, 271 U. S. 23, cited by plaintiff. That is not the case before us here. The amount which the Company would now add to its capital account was not in any reserve. It was not a part of its surplus earnings which it saw fit to invest in capital. Until the advent of this rate proceeding, it was always treated by it and the Commission as merely one of its ordinary expenses of operation and accounted for on that assumption alone.

In *Natural Gas Co. of West Virginia v. Public Service Commission* (1924), 95 W. Va. 557, 121 S. E. 716, it was said:

> "We are of opinion that in any estimate of the present fair value of the company's property, based upon reproduction cost new, less depreciation, there may properly be included in such estimate a reasonable allowance for 'overhead charges,' if such charges have not already been paid as operating expenses, but the evidence as to the amount is too uncertain in this case for us to determine any particular sum. Upon further inquiry the Commission can ascertain such amount as may be warranted by the evidence, and that sum, when so found, may be

given such weight, along with the other facts relevant to the inquiry, as the Commission may deem proper. But no allowance for overhead costs should be made where they have already been paid by the public as operating expenses. The utility should not be permitted to capitalize such overhead charges and require the public to keep on paying a return on expenses already repaid the utility. If, however, it should be found that actual expenditures have heretofore been made for overhead costs which have not been charged to and paid as operating expense, allowance should be made therefor."

In *International Railway Co. v. Prendergast* (October 11, 1932) 1 Fed. Supp. 623, 629, the three judge District Court for the Western District of New York, in expressing its conclusions in respect to the claims made for going concern value, stated:

> "In estimating going value, it is essential to refrain from charging expenditures which are properly chargeable to other accounts used in finding the rate base. Expenditures properly allowed by the commission regulating utilities as operating expenses must not be capitalized as going value."

In *Chesapeake & Potomac Telephone Co. v. Whitman* (1925), 3 Fed. (2d) 938, 954, the Court, after discussing claimed capital charges for cost of establishing the business, said:

> "Nevertheless, we take it to be clear that to deny a utility the opportunity constantly to add to the value of its property out of rates paid by the public is not confiscation."

In *Des Moines Gas Co. v. Des Moines* (1915), 238 U. S. 153, 166, the Supreme Court, after discussing a claimed

investment by the utility in organizing and establishing its business, said:

> "For aught that appears in this record, these expenses may have been already compensated in rates charged and collected under former ordinances."

We submit that the Commission's finding of historical cost, upon the Company's historical investment, but with land at its present value, was not deficient by the amount of the additional overheads claimed and that the ruling of the lower Court (R. 114, 142, 171) in sustaining the Commission should be upheld.

In addition to the historical investment in fixed capital as of January 1, 1930, including organization cost, there was included by the Commission a reasonable allowance for current working cash capital and materials and supplies, together with the Company's estimate of average additions for 1930, totaling $1,862,103. (R. 27.) The total historical rate base of $60,704,000, found reasonable by the Commission and the Court, represented, therefore, the average historical capital for the year 1930, against which the revenues for that year were tested. (R. 27, 47.)

It is respectfully submitted that the Commission's determination of historical cost rate base was fair and reasonable. Even if the Commission were in error in any particular, the validity of the order would in no wise be affected. The question of confiscation is to be determined on the fair value rate base above mentioned and the rate of return allowed under the prescribed rates. What the Commission did in determining fair value and what it allowed as a rate of return will presently be developed.

REPRODUCTION COST NEW.

Various estimates were submitted to represent the cost of reproducing the Company's gas properties new as of January 1, 1930. The variations in these estimates, particularly as between those of the Commission's and the Company's engineers, are due principally to the prices applied. The City of Los Angeles urged the elimination of certain artificial gas plants, and submitted a reproduction cost estimate with such property excluded.

Reproduction cost estimates depreciated also were submitted and will be briefly considered.

Mr. Dufour, Commission engineer, estimated reproduction cost new, using a four-year construction period, 1926-1929, with average prices for that period, to be $73,637,-542. (R. 254.) This figure includes overheads in the amount of 22.32 per cent. The witness also gave estimates using unit prices as of December 31, 1929, and June 15, 1930, with overheads of 21.65 per cent, which totals amounted to $72,898,613 and $72,467,928, respectively. (R. 256, 257.) All of the estimates of witness Dufour are undepreciated and include liberal allowances for wrought iron pipe, which allowances will be discussed at a later point in this brief.

Commission engineer Wehe estimated accrued depreciation on both the straight line and sinking fund bases. (R. 282-288.) The lives which he used in his estimates were not taken from life tables, but were the result of field inspections and an examination of past performances of this company alone. (R. 289.) His depreciation estimates result in a depreciated condition, that is, the relation between the depreciated condition and the cost

new, of 87.7 per cent on the sinking fund method and 75.6 per cent on the straight line method. These percentages include allowance for wrought iron pipe. (R. 288, 466, 467.)

Commission witness Dufour's estimates of reproduction cost new, above set forth ($73,637,542; $72,898,613 and $72,468,928), less accrued depreciation, as computed by Commission witness Wehe, on both the sinking fund and straight line methods, are reflected in the following table:

Reproduction Cost New Undepreciated	Less Depreciation	
	Sinking Fund Basis	Straight Line Basis
$73,637,542 (a)	$64,179,071 (d)	$55,676,886 (d)
72,898,613 (b)	63,909,360 (e)	55,124,928 (e)
72,467,928 (c)	63,522,153 (e)	54,785,311 (e)

(a) R. 254
(b) R. 256
(c) R. 257
(d) R. 287
(e) R. 288

Mr. Rupp, City Engineer, offered an estimate (R. 315) of reproduction cost new of the Company's gas properties, based upon Mr. Dufour's estimate of reproduction new, less depreciation, with the gas production plants and facilities eliminated. [14] The witness included only those facilities considered used and useful. With such facilities eliminated his estimate of fixed capital based upon reproduction cost new, less depreciation, was $51,831,781. (R. 315.)

Mr. Luick, Company witness, offered an estimate of $77,586,700 as of January 1, 1930. (R. 376.) This esti-

14. The gas manufacturing facilities and their very questionable usefulness will be discussed herein under a subsequent heading, "Gas Manufacturing Plants".

mate undepreciated, includes overheads in the amount of 24.27 per cent and is based on a six-year construction period with average prices as of January 1, 1930, and over a period of three years in the future as predicted by the witness. (R. 379.) The witness predicted that the prices for three years in the future would approximate the average prices which prevailed three years prior to January 1, 1930. The palpable error of this prediction will be referred to under our discussion of "Fair Value."

The estimate of reproduction cost new less depreciation offered by Company witness Luick was $74,116,374 (R. 377), he having estimated accrued depreciation on the so-called "Cost to Restore" basis at $3,470,326. (R. 380a.) This figure represents the witness's estimate of the amount of money required to restore the property to a condition as good as new. Brief reference should be made to the method followed in compiling this estimate.

On automobile equipment the witness deducted the cost of painting and replacement of tires and of parts. This would not give a car an exchange value equal to that of a new car the Company witness conceded, but he, nevertheless, accorded it a condition as good as new and allowed nothing for accrued depreciation. (R. 389.) Meters were given repairs in a similar manner in order to put them in 100 per cent service condition, whether they were one year old or twenty-five years old.

On mains and services, engineers for both the Company and the Commission relied upon a very complete record kept over a number of years showing the condition of its mains at various locations when occasion re-

quired their removal or repair. (R. 289-292, 381-383.) The Company engineer accorded a 100 per cent condition to 86 per cent of all its pipe and deducted nothing for accrued depreciation on that portion, although some of it, as shown by actual inspection, was heavily coated with rust, and the testimony of the Commission's engineer was that pipe which had been designated as Class D and given a condition as good as new, was regularly rated by the Company's foreman of construction as being in only a 70 per cent condition and showed actual pitting in the pipe as well as a heavy rust coating. (R. 291.) The theory adopted by the Company engineer in developing his estimate of accrued depreciation was epitomized in his statement that if a unit of property is in good condition, operating efficiently, and there are no worn out parts that need replacement, then the unit is as good as new. (R. 387.) Quite logically he declared, therefore, that even though he knew that one of the two pipes found in the ground is going to last for 10 years and the other for 20 years, if he found them in the same physical condition he would make the same deduction for accrued depreciation. (R. 388.) It seems apparent, therefore, that the witness wholly neglected the obvious fact that value depends largely upon expected service life. The basis of depreciation used by the Company finds no support in the authorities.

The lower Federal Courts have expressly repudiated the cost to restore basis of estimating depreciation. *International Railway Co. v. Prendergast* (October 11, 1932), 1 Fed. Supp. 623.

That the Company's estimate of depreciation on the cost to restore basis is absurdly conservative is apparent from the fact that the Company has accumulated a depreciation reserve in the amount of $9,350,639 (R. 386) for its depreciable gas property and, further, that it claims as a reasonable annual operating expense to cover depreciation the sum of $1,300,000. (R. 385.)

In addition to Mr. Luick's estimate of the costs to reproduce the physical properties new, including organization cost, he included also $8,421,470 for a remuneration to be paid to promoter and for cost of financing. (R. 377.) In its brief, appellant has made no claim for the inclusion of these items. Mr. Luick's assumptions show that gas would be unknown in Los Angeles and vicinity and that investors must be persuaded to assume the risks incident to the promotion of an unknown enterprise. (R. 386, 390.) Such an assumption is, of course, contrary to all experience. Gas has been a necessity in that community for many years and other utilities are today engaged in its distribution in and surrounding the same area. Such assumed costs are not to be included. *Galveston Elec. Co. v. Galveston* (1922), 258 U. S. 388, 397; *Greencastle Waterworks v. Public Service Commission* (1929), 31 Fed. (2d) 600, 604; *Wabash Elec Co. v. Singleton* (1932), 1 Fed. Supp. 106, 111, affirmed by this Court in *Wabash Elec. Co. v. Young,* decided January 9, 1933.

The weight to be accorded the above estimates of reproduction cost new and reproduction cost new less depreciation in arriving at its determination of fair value was within the sound judgment of the Commission. Cer-

tainly neither the Commission nor the Court was obligated to use or accept any reproduction cost new figure as its determination of fair value. *Georgia Rwy. & Power Co. v. Railroad Commission* (1923), 262 U. S. 625, 630. The ascertainment of fair value is not to be controlled by artificial rules. It must be determined by the exercise of reasonable judgment, having its basis in a proper consideration of all relevant facts. *Minnesota Rate Cases, Simpson v. Shepard* (1913), 230 U. S. 352, 434.

CURRENT PRICE LEVEL VALUES.

The Commission stated in its opinion (R. 37) that in addition to historical cost and various reproduction cost new estimates, there were submitted estimates of cost on the basis of current price level. The Commission stated:

> "Current price level estimates proceeded upon the assumption that the property was put together historically but that during its entire life prices had been those now current and that actual cost, with this adjustment for change in price level, was a reasonable and proper measure of value." (R. 37, 38.)

The following valuation estimates of record are consistent with this concept of value.

(1) At the first hearing before the Commission in this proceeding on November 13, 1929, Mr. Torrey, an engineer for the Commission, testified that by the application of price trends to the Company's average fixed capital of $58,047,366 for 1929, he found the reproduction value to be $64,104,719. (R. 229.) That result was obtained, he stated, by the use of price factors representing the level of prices obtaining at the end of 1928. At that price

level, the reproduction cost (admittedly not a true reproduction new cost estimate) was approximately 10 per cent above the actual cost of the Company's property.

(2) Commission witness Dufour estimated reproduction cost new of physical properties as of December 31, 1929, using one-day prices as of June 15, 1930, with lands at market value, but with the addition only of overheads as actually charged historically and reduced by $615,007, representing a difficulty factor which will hereinafter be explained, to be $63,212,221. (R. 460, 257.)

(3) The said current price level cost estimate of $63,212,221, using unit prices as of June 15, 1930, according to the affidavit of witness Dufour, was also obtainable by the application of price factors to the historical cost (above discussed book figure), converting said figure to price levels as of June 15, 1930. (R. 460.)

With reference to the conclusions shown under items 2 and 3 above, reflecting current price level value, Mr. Dufour stated in his affidavit:

> "The current price level cost of plaintiff's gas properties used and useful in the public service, applying prices prevailing June 15, 1930, including land at present market value as estimated by witness E. P. McAuliffe and excluding the hereinafter described difficulty factor of $615,007, is $63,212,221, undepreciated; said figure represents the cost of the properties as they existed December 31, 1929, using the unit costs and prices prevailing on June 15, 1930, and applying overhead charges of six per cent, the average amount actually charged by the company on its books from 1913 to 1929, inclusive (land as above noted, being included at its market value as of De-

cember 31, 1929); *the said figure of $63,212,221 is also obtainable by applying to the actual historical cost of the properties as of December 31, 1929, as reflected by the books of the company, price factors converting the said historical cost to price levels prevailing on June 15, 1930. Current price level cost represents the cost of the properties as they existed on December 31, 1929, assuming that the properties were put together historically, but that during the entire life and development of the properties prices and unit costs had been continuously at the level prevailing on June 15, 1930.*

The difficulty factor above mentioned represents affiant's estimate of the increased labor cost that would be experienced in constructing the property under present physical conditions over those originally encountered, such as increased traffic difficulties and increased subterranean obstructions. This increased labor cost is an incident of theoretical construction under an assumed construction period, and is properly to be excluded in arriving at a current price level cost as above defined, inasmuch as the said difficulties were not in fact experienced historically.

The current price level cost of plaintiff's gas properties, less accrued depreciation computed on the six per cent sinking fund basis, is $55,437,354 as of December 31, 1929. The said cost less accrued depreciation computed on the straight line basis is $47,866,067 as of December 31, 1929." (R. 460, 461.)

The affidavit of witness Dufour further shows that subsequent to June 15, 1930, there was a marked decline in

labor and material costs, and that the current price level cost of gas properties declined in excess of three million dollars between June 15, 1930, and December 31, 1930. The affidavit in this regard states:

> "Affiant has kept in close touch with the prevailing labor and material costs; he maintains as part of the Valuation Division a Cost Bureau which spends its entire time in collecting material and labor costs from analysis of the actual purchases made by representative public utility corporations within the State, and from quotations obtained from vendors; the present trend of material and labor cost is downward; due to the present acute unemployment situation the wages paid the class of labor required for this type of construction is now lower and due to the large number of applicants for employment from which capable men may be selected the efficiency of labor is higher, tending to materially decrease the labor costs; he has estimated that the current price level cost of plaintiff's gas properties used and useful in the public service applying prices prevailing December 15, 1930, including land market value as of December 31, 1929, and excluding difficulty factor is $60,009,099, undepreciated; said figure would represent the cost of the properties as they existed December 31, 1929, if the unit costs and prices prevailing on December 15, 1930, were used, applying overhead charges of six per cent, the average amount actually charged by the company on its books from 1913 to 1929, inclusive, and including land at market value as of December 31, 1929; that the current price level costs of $60,009,099 as of December 15, 1930, is only $1,321,912 or 2.25 per cent higher than the actual historical cost.

The current price level cost as of December 15, 1930, of plaintiff's gas properties less accrued depreciation computed on the six per cent sinking fund basis is $52,673,999 as of December 31, 1929. The said cost less accrued depreciation computed on the straight line basis is $45,522,803 as of December 31, 1929." (R. 461, 462.)

By way of a summary statement, the following table reflects the above described current price level cost estimates, depreciated and undepreciated. (R. 229, 460, 462.)

	Current Price Level	Depreciated	
		Sinking Fund Basis	Straight Line Basis
1. (Torrey) Average historical fixed capital for 1929 converted to prices of 1928 by price factors	$64,104,719		
2. (Dufour) Property as of Dec. 31, 1929, with prices of June 15, 1930	63,212,221	$55,437,354	$47,866,067
3. (Dufour) Property as of Dec. 31, 1929, with prices of Dec. 15, 1930	60,009,099	52,673,999	45,522,803

We submit that the so-called current price level cost figures, above discussed, constitute reliable evidence of value, to which the Commission and the Court below could accord appropriate weight in its determination of fair value. The consideration given to the said current price level cost estimates will be developed in our treatment of fair value, infra.

GAS MANUFACTURING PLANT.

Before discussing the fair value determination made by the Commission, particular reference should be made

to the artificial gas manufacturing plants of the Company and the treatment accorded this property.[15]

The Company possesses facilities for the manufacture of gas from oil, consisting of three units and having a total capacity of 98,500,000 cubic feet per day. The first was constructed in 1907, and was reconstructed along with Plant No. 2 in 1921, and Plant No. 3 was constructed from 1923 to 1924. (R. 416.) The gas manufactured in such plants has a heating value of from 550 to 600 B. T. U. (British Thermal Units) per cubic foot, whereas natural gas contains from 1100 to 1150 B. T. U. (R. 469.) Prior to April, 1927, the Company served a mixed gas to its consumers, but since that date has supplied natural gas only, and has not manufactured any gas except on one occasion, March 13, 1928, when the collapse of the St. Francis Dam interrupted the use of one of the natural gas pipe lines which supplied its needs. On that day it was anticipated by the Company that there would be a shortage of natural gas, but that shortage did not materialize. (R. 343.) The quantity actually manufactured on that day by its Plant No. 3 was 569,000 cubic feet, representing on a cubic foot basis but nine-tenths of one per cent of the total gas sendout on that day (R. 468) and about one-half that ratio on a heating value basis.

In the affidavit of the Commission's engineer Brown (R. 469), the use made of these plants is shown as follows:

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15. Before coming to the summary of "Fair Value" under our discussion of "Value of Property", we will separately discuss the gas manufacturing plant, going concern value and other capital items, all of which entered into the Commission's determination of "Fair Value".

Plant	Number of Days Heated	Amount Manufactured
	Winter of 1927-1928	
Plant No. 1	47	0
Plant No. 2	38	0
Plant No. 3	155	569,000 c. f.
	Winter of 1928-1929	
Plant No. 1	0	0
Plant No. 2	0	0
Plant No. 3	41	0
	Winter of 1929-1930	
Plant No. 1	0	0
Plant No. 2	0	0
Plant No. 3	85	0

Mr. Brown further states that such manufacturing plants do not constitute satisfactory or economical reserve or standby facilities. Consumers' appliances may not be readily adjusted to burn the gas of lesser heating units.

The gas appliances of the Company have been adjusted to burn natural gas, having an average heating content of 1100 B. T. U. per cubic foot, and would not satisfactorily burn artificial gas without adjustment. (R. 469.) In the type of gas plant owned by the Company it is not possible to economically manufacture a gas having a higher value than 625 B. T. U. per cubic foot. (R. 469.) According to witness Brown, the gas generating equipment is no longer used or useful. (R. 470.)

The Commission said that the evidence convincingly establishes the existence of a natural gas supply adequate for years to come. There was competent evidence in the

record to that effect. Mr. Dodge, chairman of the Division of Petroleum Engineering of the University of Southern California, testified that the supply of gas from presently known sources would exceed the full demands of the distributing utilities, after allowing for expected increase in demand, until at least the year 1945. (R. 304-314.) Public and private gas conservation measures and the possibility of the constant discovery of new sources may extend the use of natural gas for domestic and commercial purposes for an indefinite period.

The reproduction value of the manufacturing facilities included in the Company reproduction cost new estimate was $12,134,665, while the historical cost of said facilities included in the Company historical reproduction cost was approximately $10,532,542. (R. 397.) The actual book cost of the gas manufacturing plant was approximately $10,000,000. (R. 499.) According to Commission witness Brown, the portions of the production plants now being used and useful, which were included in the Company reproduction cost new estimate by Company witness Luick, was by him valued at $7,105,900. (R. 470.)

The treatment which the Commission accorded the gas manufacturing plant in arriving at its historical cost and fair value rate bases should be particularly noted.

In arriving at historical cost it included in the base figure the full cost of the plant, although in effect it found that the manufacturing facilities had been rendered unnecessary by the introduction of natural gas. It is clear from the Commission's opinion that the plant was included in the historical cost base figure on the prudent investment theory, the investment, when made, at least, being

a proper and necessary one. The Commission stated in this regard:

> *"No deduction is made on account of the Company's artificial generating plants and equipment being rendered unnecessary by the introduction of natural gas.* There can be no question that money invested in these was invested prudently and in good faith. When made, at least, the investment was a proper and necessary one. The theory of the basis of testing rates here under consideration contemplates protection of investments thus made. Were the cost of these plants deducted from the base it would be necessary to provide for its amortization. The City's setup provides for their amortization over a longer period of time than their normal life expectancy upon which current depreciation expense is calculated. A shorter and more logical amortization period would substantially change the result. While the evidence adduced by the City in respect to these plants presents a serious question as to whether all of the investment they represent should be continued in the rate base, it is not established with sufficient definiteness that the elimination of the whole or a part of the investment would be fair to the Company, or to the interest of the consumers. *A somewhat different situation arises in connection with the Company's claims to the reproduction value of these plants."* (R. 32, 33.)

In determining the fair value rate base, the Commission stated that the very doubtful need of the plant had an appreciable adverse effect upon its fair value. The Commission did not fix in dollars the extent of this adverse effect upon value, but definitely recognized it to exist. The Commission stated:

> *"The evidence convincingly and satisfactorily establishes the existence of a natural gas supply adequate for years to come.* This presents a serious question as how the artificial gas plants of the Company should be treated. Are they all necessary as a standby or would a part of them be adequate for this purpose? Under the basis of fixing rates heretofore followed by the Commission, which essentially is to provide a fair return on money prudently invested, if any part of these were eliminated as operative property it would follow that provision would be made for the amortization of the money invested in them. In Part I some consideration was given to the matter of these plants and the conclusion reached that the evidence under all of the circumstances did not justify their retirement and amortization at this time. *A different situation is presented when the Company demands a return on the present fair value of its property, for the somewhat doubtful need of all of these plants does have an appreciable adverse bearing upon their value as included in the rate base figures in Tables IV and V."* (R. 49, 50.)

The lower Court, in discussing the gas manufacturing plant, recognized that the Commission had been extremely liberal in its treatment. The Court, in the majority opinion, said:

> "The Commission was very liberal in its treatment of certain items of property. The Company in its early operations furnished artificial gas. Since 1924 it has served natural gas, which is plentiful in the numerous oil fields in Southern California. There is no evidence which discredits the Commission's conclusion that the supply of natural gas will be abundant and constant. The Commission found in effect that at least two of the artificial gas manufacturing

plants of plaintiff were no longer needed and might well be retired. Nevertheless, it included them in its valuation as a live necessary part of the operative property. It appears that had these plants been eliminated the fair value base would have been reduced by approximately $3,000,000." (R. 112.)

Circuit Judge Wilbur, in his concurring opinion, stated that the Commission included the gas manufacturing plant property on the untenable prudent investment theory, and indicated that the error of inclusion would compensate for any possible comparable error should some element of value have been omitted by the Commission in its total fair value figure. Judge Wilbur said:

> "*It will be noted that the Commission is of the opinion that a finding that the manufacturing plant was neither used nor useful and therefore that its value should be deducted from the rate base would necessitate the return of such lost value to the Company by rates which would require the consumers of gas to pay therefor, in installments over a period to be fixed by the Commission. A theory entirely untenable upon the basis of the decisions of the Supreme Court.* The real question is whether its value can justly be included, in whole or in part, in the rate base, and to that extent only can its value be considered. It is also found by the Commission that, 'The evidence convincingly and satisfactorily establishes the existence of a natural gas supply adequate for years to come.' It is obvious that the Commission, in continuing as a capital investment the manufacturing plant of the Company, did so on the untenable prudent investment theory. Neither the Company nor the Commission complained of this method of treatment of the obsolete manufacturing plant of

the Company, and the City of Los Angeles only mildly complains thereof and suggests that the finding of the Commission, being an exercise of sound discretion, is binding. But we are not bound by the decision of the Commission. If we were this suit would be at an end. For instance, if it appears from the record that the Commission has included in its rate base $10,917,727 of worthless property upon which the Company is not entitled to income and has erroneously excluded a like amount upon which the Company is entitled to an income (such as going concern value, etc.), we could not hold that the rate was confiscatory because the rate base was too small. On the contrary, the rate base would be exactly correct. While rates fixed by rate-making bodies are attacked in the courts upon a claim of confiscation advanced by the public utility corporation, the rate fixed may be actually excessive instead of confiscatory. A fair minded Commission is apt to err in favor of the Company as in favor of the consumer. It may be the duty of this court in determining the question of confiscation to determine the question as to whether or not the historic or reproduction cost of the gas manufacturing plant of the company, or any part thereof, is to be included in the rate base notwithstanding the fact that the Commission included it in its rate base. We are, however, only concerned with the question of confiscation, and if we can say that the rate fixed is not unreasonable, having due consideration for the factors involved including the admitted partial, if not total, obsolescence of the manufacturing plant, it will be unnecessary to attempt the solution of the problem which has been considered doubtful by the Commission and been avoided by the parties other than the intervening cities of Los Angeles and Pasadena." (R. 152, 153.)

With further reference to the gas manufacturing plant, Judge Wilbur stated in his opinion:

> "The solution adopted by the Commission in the case at bar was to treat the manufacturing plant as a stand-by plant. It is the duty of the fact-finding body to take into consideration the historic cost as well as the reproduction cost in fixing value and we believe that in case of obsolescence due to the discovery of natural gas or new machinery for the making of gas, that the court in determining the rate base should lean toward the historic cost rather than toward the reproduction cost, that is, should give some value to the displaced machinery or plant, to the end that a going public utility may in the long run receive an adequate return upon its property." (R. 159.)

The Commission and the lower Court were clearly justified in recognizing that the questionable use of the gas manufacturing plant had an appreciable adverse bearing on its value. As was forcibly said in *United Fuel Gas Co. v. Public Service Commission* (1926), 14 Fed. (2d) 209, 214, affirmed 278 U. S. 300:

> "Very possibly, it would cost something in that neighborhood to duplicate in one continuous operation all the plaintiff's present plant. It is true that there is no occasion for any such duplication. Plants of the size and more or less scattered character of that of the plaintiff are seldom or never constructed in the manner assumed by the reproduction theory. Nevertheless, because there is usually no other way of arriving even approximately at the fair market value of the utility's property, commissions and courts are forced to give great weight to what the evidence shows the cost of reproduction would be. In so doing, however, it is only fair to bear in mind

how seldom a purchaser of such a utility, no matter how free a market for it there might be, would feel justified in paying for it as much as it would cost to reproduce all of its property, even after making proper allowance for any physical depreciation it had undergone.

No wise man would incorporate in a newly constructed plant duplicates of not a little which in the old still served its turn well enough. The money could be used to far better advantage."

In the dissenting opinion of Mr. Justice Brandeis in the *O'Fallon Railway Case, supra,* it was said at page 517:

"Independently of any statute, it is now recognized that, when in confiscation cases it is sought to prove actual value by evidence of reproduction cost, the evidence must be directed to the present cost of installing such a plant as would be required to supply the same service. For valuation of public utilities by reproduction cost implies that 'the rates permitted should be high enough to allow a reasonable per cent of return on the money that would now be required to construct a plant capable of rendering the desired service'; and does not mean 'that the plant should be valued at what would now be needed to duplicate the plant precisely.' Proof of value by evidence of reproduction cost presupposes that a plant like that being valued would then be constructed.

* * * * * * *

"The Commission when requested to consider evidence of reproduction cost must, therefore, examine the value of every part of the plant, and that of the whole plant, as compared with the value of a modern, efficient plant. Upon such consideration the Commission may conclude that the railroad is so largely obsolete in construction and equipment as to render evi-

dence of the reproduction cost of the identical plant of no probative force whatsoever."

GOING CONCERN VALUE.

Appellant contends that the Commission and the lower Court erred in their treatment of going value, and that the fair value rate base should have specifically included an allowance for this item of not less than $9,228,667. We will demonstrate that the Commission recognized the element of going value in a substantial amount and gave due and proper consideration to the existence of such value in fixing its fair value rate base and in the rate of return allowed. In our presentation of this subject we will briefly discuss the evidence on going concern value, what the Commission did in its opinion and what the lower Court held.

Two Company witnesses testified on going value. Witness Miller stated that, in his opinion, such valuation amounted to not less than $9,228,667. His figure was made up of his estimated cost to attach and develop the business and cost of organizing the property and personnel. His concept was one of endeavoring to determine the capital cost of developing the existing business over a given construction period and at the end of the assumed period to determine the deficiency earning below an 8 per cent return on all money invested during said pioneering period. To the total amount of the deficiency return below 8 per cent on the investment, realized during the assumed seven-year development period, $8,721,878, the witness added $506,789 to cover assumed additional

cost resulting from labor inefficiency during the first three years of operation. In other words, it was assumed that no experienced labor could be obtained and that the staff would be specially trained. The total of the two figures above given amounted to $9,228,667. An examination of the testimony of the witness shows that he has assumed the sufferance of early losses due to decreased operating revenues and increased operating expenses during the construction and development period. Such losses he carries from year to year to capital, together with interest thereon at the rate of 8 per cent. He states that these are costs which are actually incurred, or would be incurred under an assumed reconstruction of the property. (R. 413.) The exhibit of this witness (Company Exhibit 36) is reproduced in full in the record and clearly demonstrates the highly theoretical method pursued. (R. 404-410.) The result is based upon innumerable assumptions and most any figure desired can be obtained by varying the basic assumptions. The exhibit, under any view, is not convincing and the Commission was not obliged to accept the conclusions drawn therein.

Mr. Luick also testified for the Company and expressed the view that the property was possessed of going value of not less than $10,000,000. (R. 392.) In arriving at his conclusion three guides were used. The first two were based upon his judgment that a purchaser will ordinarily pay for a utility property with established earnings an amount equal either (1) to one year's gross revenue over and above the value of its physical property, or (2) 15 per cent above the cost of reproduction. His third guide was the estimated cost of attaching new consumers. The

latter test he stated applied solely to a reproduction cost new valuation. Like the estimate of Mr. Miller for the cost of attaching the business, this estimate represents assumed expenditures during the development of the business and an assumed sacrifice upon the part of the stockholders. In other words, it is merely a capitalization of an assumed deficiency in earnings. (R. 396.)

The first two tests of the witness are not based upon any value which a supposed purchaser will actually find in the property, but upon the fact that the business is now being operated at a profit. The theory of the witness, as plainly stated (R. 395), is that many utilities, which are unable to earn a full fair return, have no going concern value, while those that do earn a fair return, or have a constitutional right to do so, do possess such a value. Further, it was said, that such a value, if it exists at all, would be measured apparently by adding one year's gross revenue, or fifteen per cent, to the reproduction cost of the utility property.

Obviously, the value of a regulated business cannot be based on the rates allowed or the profits derived, nor can value depend upon a constitutional right to earn a fair return. Although the Commission witnesses expressed no opinion on going value, the Commission was not, therefore, bound to accept the estimates of the Company witnesses. Proof requires persuasion, and such testimony was far from being persuasive. Many facts in the record having a bearing upon the inherent value of these properties were considered by the Commission, some of which we submit directly negative the Company's claim of value for this item. (Commission Decision, R. 49, 50.)

Authorities on Going Concern Value.

Under the authorities, it is well established that going value cannot be allowed for uncompensated inception costs, nor is it mere good will, both of which have been excluded as allowable elements in rate cases. (*Knoxville v. Knoxville Water Co.* (1909), 212 U. S. 1; *Galveston Elect. Co. v. Galveston* (1922), 258 U. S. 388; *Georgia Ry. & Power Co. v. Railroad Commission* (1923), 262 U. S. 625; *Board of Public Utility Commissioners v. New York Tel. Co.* (1926), 271 U. S. 23.)

No exact definition or measure of going value has been attempted by the Courts. In the principal case on this element of value, *Des Moines Gas Co. v. Des Moines* (1915), 238 U. S. 153, 165, it was said:

> "That there is an element of value in an assembled and established plant, doing business and earning money, over one not thus advanced, is self-evident."

And the Court further said:

> "Each case must be controlled by its own circumstances."

The elements that shall be considered in arriving at going concern value, the Court in that case said, were briefly:

1. Time and money expended in the promotion of the enterprise, in the organization of the company, including legal expenses in obtaining the franchise and incorporating the company;

2. Engineers' fees in preparing plans and specifications, making surveys and superintending the construction of the plant;

3. Losses arising from accidents and injuries to workmen as well as to the material during construction;

4. Contingencies arising from lack of foresight;

5. Cost of administration;

6. Interest on money invested in the construction;

7. Taxes during construction.

In *Southwestern Tel. Co. v. Houston* (1920), 268 Fed. 878, 883:

> "The cost of creating such going concern value was paid as expenses of operation out of the revenues of the company, much of it since 1909. When the council, in that year, fixed the present schedule of rates, as to which no complaint was made by the company until December, 1917, it must be presumed that the council gave full consideration to all operating expenses in determining a fair rate. Such expenses, so paid out of the company's revenues, cannot be said to be 'capital actually invested,' and should not be included in the total valuation on which plaintiff is entitled to receive a fair return."

And on appeal in *Houston v. Southwestern Bell Telephone Co.* (1922), 259 U. S. 318, 325, this Court had this to say of the lower Court's finding.

> "Whether going-concern value should be considered and allowed at all in determining the base for rate-making, and, if allowed, what the amount of it should be, depends upon the financial history of the Company (*Galveston Electric Co. v. Galveston,* decided April 10th (258 U. S. 388, ante 678, 42 Sup. Ct. Rep. 351)), and it is impossible for us to determine whether the requisite history for deciding this question is to be found in the three large volumes of the

transcript of the record of the case, containing 1,664 pages, without reading the whole of it."

In *Idaho Power Co. v. Thompson* (1927), 19 Fed. (2d) 547, 559, the Court, after referring to the many decisions of this Court on going value, remarked:

> "As we construe these cases, they do not sustain the broad contention of either party. From all of them we deduce the view that commissions charged with the duty of fixing reasonable rates, and courts charged with the responsibility of restraining confiscation, are to give consideration to all proper elements of actual value, and may not adopt going value in a broad, indefinite sense, or reject its substantial elements *when they are shown to exist. Nor under the guise of going value should an element be again considered which has been given proper place under some other head.*"

In *International Railway Co. v. Prendergast* (October 11, 1932), 1 Fed. Supp. 623, 629, the Court stated:

> "In estimating going value, it is essential to refrain from charging expenditures which are properly chargeable to other accounts used in finding the rate base. Expenditures properly allowed by the commission regulating utilities as operating expenses must not be capitalized as going value. McCardle v. Indianapolis Water Co., 272 U. S. 400, 47 S. Ct. 144, 71 L. Ed. 316; Galveston Elec. Co. v. Galveston, 258 U. S. 388, 42 S. Ct. 351, 66 L. Ed. 678; City of Omaha v. Omaha Water Co., 218 U. S. 180, 30 S. Ct. 615, 54 L. Ed. 991, 48 L. R. A. (N. S.) 1084; Knoxville v. Knoville Water Co., 212 U. S. 1, 29 S. Ct. 148, 53 L. Ed. 371; New York Tel. Co. v. Prendergast (D. C.) 36 F. (2d) 54; Nat. Waterworks Co. v. Kansas City, 62 F. 853 (C. C. A. 8.)
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"Going value must not be ascertained by a formula of capitalizing alleged past deficits. Galveston Elec. Co. v. Galveston, 258 U. S. 388, * * *."

In its treatment of the Company's claim of going concern value, the Commission stated:

"The Company claims $9,228,667, as going concern value based largely upon the testimony of Col. Alten S. Miller. This claim is associated with the Company's reproduction new valuation and is built up on theories and methods analogous to those employed in respect to the structural properties. Just as these theories and methods lead to extreme results when applied to plant, they lead to this large figure when it is sought to measure the cost of attaching the business under a theoretical reconstruction program. Under the methods employed by Col. Miller the results vary widely according to the assumptions respecting this program. Indeed, it may be said that by altering the assumptions, particularly those as to the rate at which business is attached, almost any desired result may be obtained. A careful analysis of Col. Miller's exhibit and testimony makes it plain that in his total figure there is contained a very substantial sum on account of assumed early losses.

Were going concern to be treated as an independent item of value, it should be measured with due regard to actualities rather than upon theories and assumptions such as employed by Col. Miller. And it would seem that what it did cost this Company to attach its business is a far more reliable guide than an estimate of what it might cost under a theoretical reconstruction program. By the prescribed accounting rules all costs incident to attaching business are required to find lodgment in New Business Expense. Col. Miller's position in essence is an attack upon the classification of New Business Expense as an

operating item, his line of reasoning inferring that this expense should have been added to capital year by year. Were new business expense to be added to capital the corollary would be its elimination from operating expense. No very appreciable change in result would follow from allowing a reasonable amount in rate base to represent the cost of attaching the business (following largely Col. Miller's theory but reducing theory to actuality) and at the same time disallowing New Business Expense in operation.

It is true that Col. Miller includes in his total figure $506,789, as 'cost of organizing property and personnel' but he does not attempt to explain how this figure is arrived at. The actual cost of building up the personnel and organizing the property has of course, under accounting procedure and Commission practice, been included in current operating expense, and if viewed in the light of capital expenditure, just as in the case of the cost of attaching the business, has been taken care of and in effect amortized year by year as incurred.

Substance rather than form is to be considered. So viewed, this Commission does allow for the so-called intangible going concern value by treating its cost as a current operating expense." (R. 40-42.)

Further, it was pointed out by the Commission:

"Had new business expense been accounted for as a capital item capital would have been augmented in round figures by the sum of $1,358,000, during the period 1913 to 1929, inclusive, or at the rate of $5.42 per independent active meter. At the close of 1929 the Company had 346,000 meters, which at this average cost would represent in round figures a total cost of $1,875,000. New business expense as incurred ranged from $109,000 to $114,000 a year in recent years." (R. 41.)

The opinion of the Commission shows that in this case a liberal allowance for new business expense in the amount of $114,000 was included in operating expenses in fixing rates for the future. (R. 47.)

The affidavit of Mr. Stein, Commission Accountant, shows: (1) that the annual costs incurred in the development of new business was treated, under the uniform classification of accounts of the Commission, as operating expenses and not as capital items (R. 472-475) and that during the period 1913-1929 a total of $1,358,217.66 has been paid as operating expenses for this development cost (R. 472); (2) that all costs incurred by the Company in the training of its personnel and its operating organization have been charged to new business expense, or otherwise charged to expense of operation. (R. 475.)

The lower Court in its majority opinion, after stating that the Commission had been extremely liberal in its treatment of certain items of property such as the gas plant, observed that:

> "The large amounts claimed by the Company for cost of financing, $5,921,470; promoters remuneration, $2,500,000; cost of attaching business (going concern value), $9,228,667; added 'difficulty' costs, $580,195; we think were properly rejected as for their total amounts. The Company's claim was that these sums should be added to the present investment cost of its property on the theory that in fixing fair value it was entitled to assume an original venture to be promoted and built up over a contemplated period of eight years, saying, in effect:
>
> 'If we were starting today to develop our business anew, without capital or customers, all of the amounts enumerated would probably be expended.'

> Basically, the object of an appraisement for rate making purposes is to find the full value of the investment in the business. The investment is represented by the *value* of the property used and necessary in the business—not what it would cost to promote and establish a like business starting today." (R. 117.)

Circuit Judge Wilbur discussed going concern value at considerable length (R. 135-140) and concluded that such value had been adequately allowed and recognized by the Commission in its fixing of rates, pointing out (1) that current operating expenses were allowed from year to year to cover the development of going concern value (R. 125, 138); (2) that historically a portion of the cost of development of such value was capitalized in historic overhead costs (R. 138); (3) that the rate of return allowed by the Commission, permitting a liberal margin of earnings over and above the cost of bond and preferred stock money, was a partial recognition of going concern value. (R. 139-140.)

Going concern value and its treatment will be further discussed under our heading on fair value, to follow.

OTHER CAPITAL ITEMS.

In the fair value accorded by the Commission to the Company's gas property, to be discussed presently under the next heading, the Commission provided for current working cash capital, materials and supplies, and the average estimated additions for 1930. The total included was $1,862,103. (R. 27.)

Working cash capital of $645,000, as estimated by the Commission's witness Guillou (R. 243) was accepted.

The Company's witness Luick, in computing the amount to be allowed for this item ($2,333,850, R. 367, 373) assumed that cash would be required equal to the total of all accounts receivable from consumers for gas service rendered, regardless of the outlay incurred in rendering such service. He stated that whether or not the Company would really need cash of that amount to carry on the business, was, to him, a question foreign to the allowance for working cash capital. (R. 374.)

The Commissioner's engineer adopted a different theory and, we submit, the correct theory for the estimation of the working cash needs of the Company. The only actual cash required, obviously, is that to be used in defraying the current costs of rendering service until collections may be made from consumers. The Company has no need for a supply of cash equivalent to the retail price of gas delivered or held for delivery, the total of which includes not only the actual expense of production and distribution, but also a capital return in the way of profits together with a depreciation allowance for the replacement of capital. As was pointed out by Mr. Guillou, only one third of the cash disbursements of the Company are for expense of operation. (R. 243.) The lower Court was unanimous in its finding that the allowance for this item was ample. (R. 118, 172.)

The Court also found the Commission's allowance of $450,000 for materials and supplies to be adequate. (R. 118, 173.) The Commission's engineer Guillou testified (R. 244, 245) that only $158,000 should properly be included in the rate base for this item for the reason that the remaining materials and supplies kept on hand were for new construction purposes and the Company was

annually charging interest thereon under the heading of interest during construction from the time purchased. The Company's witness conceded that they should not be charged with interest and at the same time included in capital. (R. 391.) The Commission's allowance, as its opinion shows (R. 32), was made upon the assumption that the Company would continue to charge interest on that portion of the materials and supplies held for construction purposes. The allowance of $450,000 was, therefore, extremely liberal.

The inclusion for expected additions and betterments in 1930 was $767,103, this representing one-half of the estimated total for the year. Judge Wilbur, in his concurring opinion, stated that the Commission had erred in this respect in not including the estimated total for the year. (R. 172.) It should be pointed out, however, that the Commission was not fixing a rate base for 1931, the year in which the rates prescribed were to take effect, but was merely testing rates prescribed for the future by applying them to the average capital for 1930, and upon estimated revenues and expenses for the same year. The year 1930, as well as preceding years, with certain qualifications (R. 51-53), were used as a basis for testing future results. The additions to the Company's plant in 1931 and future years obviously would increase the rate base to be used for each succeeding year, but should rates be tested upon a rate base applicable to a future year, there would likewise be applied other revenue and expense estimates. New extensions to the plant presumably yield their proportion of annual gross and net revenues. It is submitted that the Commission's inclusion of only the average capital for 1930, against which it applied the net revenue for that period,

was the only correct method of obtaining the true results of operation for that year and a representative result for the future. No suggestion was made before the Commission for the adoption of any other test.

FAIR VALUE.

Before the Commission the Company claimed a fair value rate base of $95,767,351 made up of the Company estimate of reproduction cost new of the physical properties augmented by a number of extreme claims. The detailed make-up of the rate base claimed by the Company is set forth in the opinion of the Commission (R. 36) as well as the Commission's criticism of the same.

The appellant in its appeal does not claim that the Commission erred in its failure to accept the Company's claims as to rate base, so there is no need for further discussion with reference to the same. In its attack on valuation it is the Company's contention, as we understand its brief, that the Commission failed to give any consideration to either historical cost, reproduction cost new or going value in its fixing of fair value and for that reason the Commission order was arbitrary and unlawful.[16]

Further analysis of the Commission's opinion and the procedure followed by it in its fixation of fair value will show these contentions to be without merit and that the authorities relied upon are inapplicable to the facts of this case.

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16. In this regard the appellant relies particularly upon *Northern Pacific R. Co. v. Department of Public Works*, 268 U. S. 39; *Chicago, M. & St. P. R. Co. v. Public Utilities Commission*, 274 U. S. 344; *Bluefield W. W. & I. Co. v. Public Service Commission*, 262 U. S. 679. (Company Brief, p. 45.)

The fair value rate base fixed by the Commission for 1930 was $65,500,000.[17] (R. 43-44.) The opinion does not state the precise make-up of the figure, although it is apparent that it contains $1,862,000 for working cash, materials and supplies and additions and betterments for 1930. (R. 27, 44.) The figure of $65,500,000 is undepreciated and, according to the Commission finding, is subject to a deduction for accrued depreciation of not less than $7,650,000. (R. 43.)

In making its finding of fair value the Commission states:

> "Subject to deduction for accrued and realized depreciation in a sum of approximately $7,650,000, the fair value of the property here involved as a going property with business attached, giving full effect to the current level of prices and allowing for any intangible elements of value not fully cared for in the usual and current operating expense allowances but excluding various built up claims of value incident to a reproduction of the property under an assumed reconstruction program as too uncertain and hypothetical to enter into a rate base figure, did not for the year 1928, using round figures, exceed $62,500,000, and for the year 1929 $64,000,000, and for

17. *Commission Fair Value Rate Base for 1930:*

Working cash, materials and supplies and additions and betterments 1930	$ 1,862,000
Tangible and Intangible Property	63,638,000
Total	$65,500,000
Subject to Accrued Depreciation in amount not less than	$7,650,000

the year 1930 does not exceed $65,500,000,[18] which figures, for the purposes hereof, are spoken of as rate base. These figures include the allowances for additions and betterments, working capital and materials and supplies corresponding to those included in the rate bases set out in Table II." (R. 43-44.)

The Commisssion decision shows that the fair value determination was made only after a complete and careful consideration of the entire record and particularly all of the evidence on valuation. The Commission set up in its opinion a table (Table III, R. 39) reflecting in detail many of the varied estimates of cost and reproduction cost new, and with reference thereto stated:

"In addition to actual cost and historical cost estimates, to which reference has been made in Part I, there were made estimates of cost on the current price level basis, both undepreciated and depreciated, as well as various so-called reproduction cost new and reproduction cost new less depreciation estimates, the estimates varying widely in result according to the particular assumptions upon which grounded or particular method or theory employed. Table III lists the more important of these, the valuations being as of December 31, 1929, and covering only the usual capital accounts. Material and supplies, working cash capital and various claimed intangibles are not included. Current price level estimates proceeded upon the assumption that the property was put together historically but that during its entire life prices had been those now current and

18. Through typographical error this figure appears as $65,000,000 in the record and, obviously, should be $65,500,000. (Compare set-up in Table IV and V of Commission opinion, R. 45, 47.)

that actual cost, with this adjustment for change in price level, was a reasonable and proper measure of value. Reproduction new estimates went upon the theory that value can best be measured by theoretically reproducing the property under an assumed reconstruction program. Some of the differences which appear in these estimates are due to a relatively small difference in the value placed upon land. Others are explainable by minor differences in practice in applying prices. The large differences, however, find their explanation in the varying assumptions and the results which follow these as they are reflected in overhead allowances, estimated difficulty factor costs and the like. The wide variances in accrued depreciation figures find their explanation in the diverse theories or assumptions upon which based and from which the results flow. Curiously enough, the effect of change in price level is one of the least important factors contributing to many of the results expressed, the extreme range of the effect given to this running from $3,086,000 to $5,900,000, or, expresssed in percentage on actual historical cost, from 5.6 per cent to 10.6 per cent. Even this range is lessened when certain factors appearing perhaps in one estimate and not in another are taken into account." (R. 37-38.)

With further reference to the various estimates on valuation the Commmisssion stated:

"Results such as heretofore indicated and as expressed in the table necessarily draw into question the soundness of the methods, theories and assumptions leading up to them. It is one thing to attempt in a sane and reasonable way to estimate and give effect to changes in prices. It is quite another matter, because there is a change in price levels to devise and

utilize formulas and methods for measuring its effect, which result in values and claims of value far in excess of what the property would have cost if current prices had prevailed during its entire life.

Except for realized depreciation, 'reasonable cost,' as said by the court in McCardle v. Indianapolis Water Co., 272 U. S. 400, 'is good evidence of * * * value at the time of the construction. And such actual cost will continue fairly well to measure the amount to be attributed to the physical elements of the property so long as there is no change in the level of applicable prices.'

Regulatory bodies, such as this Commission, naturally prefer to deal with actualities rather than theories and assumptions. Actual cost may be determined with a high degree of precision; and the effect upon such actual cost of the simple and single assumption that current prices prevailed during the life of the property may likewise be determined with a definiteness sufficient for the purposes of measuring the effect of higher price levels. Cost with adjustments for changes in price level and allowance for realized depreciation should be and is, for the purposes of this part, taken as a dominant consideration in arriving at a current value of the property here involved. It is deemed a much simpler, safer and more dependable guide than estimates based upon rebuilding the property under a hypothetical construction program under conditions which do not and could not reasonably exist and with farfetched assumptions which make possible almost any result desired by their designer." (R. 39-40.)

The foregoing quotation states that the Commission gave a dominant consideration to "Cost with adjust-

ments for changes in price level and allowance for realized depreciation * * * in arriving at a current value of the property here involved."

The foregoing quotation does not indicate that the Commission ignored any evidence on valuation in reaching its conclusion or that it gave to any evidence less consideration than was warranted, as appellant would have the Court believe. The Commission exercised an enlightened judgment and certainly was not bound to accept any particular reproduction cost new estimate or historical cost estimate as a measure of fair value. Nor was the Commisssion obliged, under the decisions of this Court, to strike an arithmetical average of all estimates of cost and arrive at a composite figure. In the exercise of an enlightened judgment a regulatory body must, of necessity, on a given record follow some particular method or estimate as most indicative of fair value.

In order that the Court may readily visualize the various estimates and data on valuation of Company properties as of December 31, 1929, which were before the Commission, most of which have been analyzed hereinabove, we present such valuation estimates in the table following.

	Commission	Company	City
1. Historical Cost 1915 Valuation plus book additions and betterments	$58,687,186 (a)		
2. Historical Reproduction Cost Estimates	61,019,662 (b)	$63,413,246 (c)	$49,623,807 (d)
3. Reproduction Cost New Estimates	73,637,542 (e)	77,586,700 (f)	
4. Estimate No. 3 above less depreciation straight line basis	55,676,886 (g)		
5. Estimate No. 3 above less depreciation sinking fund basis	64,179,071 (g)		51,831,781 (h)
6. Estimate No. 3 less depreciation on "Cost to Restore basis"		74,116,374 (i)	
7. Reproduction Cost New	72,898,613 (j)		
8. Estimate No. 7 less depreciation straight line basis	55,124,928 (k)		
9. Estimate No. 7 less depreciation sinking fund basis	63,909,360 (k)		
10. Reproduction Cost New	72,467,928 (l)		
11. Estimate No. 9 less depreciation straight line basis	54,785,351 (k)		
12. Estimate No. 9 less depreciation sinking fund basis	63,522,153 (k)		

(a) R. 27, 39.
(b) R. 252.
(c) R. 366.
(d) R. 315. Gas plant facilities not considered useful are eliminated.
(e) R. 254. 4-year average prices 1926-1929.
(f) R. 376. Average prices Jan. 1, 1930, and 3 years prior thereto.
(g) R. 287.
(h) R. 315. Gas plant facilities not considered useful are eliminated.
(i) R. 377. Depreciation computed on so-called "Cost to Restore Basis".
(j) R. 256. Prices of Dec. 31, 1929.
(k) R. 288.
(l) R. 257. Prices as of June 15, 1930.

13. Current Price Level Cost	63,212,221 (m)
14. Item No. 13 less depreciation straight line basis	47,866,067 (n)
15. Item No. 13 less depreciation sinking fund basis	55,437,354 (n)
16. Current Price Level Cost	60,009,099 (o)
17. Item No. 16 less depreciation straight line basis	52,673,999 (p)
18. Item No. 16 less depreciation sinking fund basis	45,522,803 (p)
19. Current Price Level Cost	64,104,719 (q)

(m) R. 460. Prices June 15, 1930—overhead costs on basis charged on books 1913-1929.
(n) R. 461.
(o) R. 461. Prices Dec. 15, 1930—overhead costs on basis charged on books 1913-1929.
(p) R. 462.
(q) R. 229. Average capital 1929 converted to prices of 1928 by price factors.

The lower Court in approving the finding of the Commission with reference to fair value held that the Commission had carefully considered all pertinent evidence of record.

> "What the Commission did then in reaching its base rate figure of fair value was to include all items of property used and useful in the operative plant of the plaintiff, and appraise the value thereof at current market prices. It included original organization costs and franchise value as well. It assumed a live active plant, and affirmed that the ultimate total included all costs of attaching business as the same had accrued and been accounted for. Its fair value figure, assuming the correct estimate and allocation of items hereinafter referred to, was one which essen-

tially represented the investment cost at the present time, of all the operative property and its connected incidentals. The Commission used the books of the Company, which furnished it with the details and items in complete form. *Other engineers who testified as to valuation figures, declared under oath that they were familiar with the properties of the plaintiff and had made a thorough and exhaustive study of all the matters as to which they gave information, and upon which the Commission based its order. An examination of the voluminous record, including the innumerable tabulations showing the various comparisons made, demonstrates that there was no lack of attention to every element and item which would assist the Commission in arriving at what it deemed to be a fair value figure."* (R. 113-114.)

In considering the adequacy of the fair value rate base found by the Commission this Court should not lose sight of the fact that the great volume of the properties of the Company were constructed in a period of high prices, much higher than those prevailing in 1930 and subsequent thereto. Under such circumstances an enlightened Commission, in the exercise of intelligent judgment, should incline to a fair value figure more closely approximating historical cost rather than reproduction cost new.

Table I of the Commission's opinion (R. 24) reflects the remarkable growth of the gas capital[19] and shows

19. The historical rate base of the Company increased, according to the Commission's decision, as follows (R. 24):

	Rate Base
1916	$12,592,434
1920	15,211,534
1925	51,317,326
1929	59,070,663

that of the total gas capital of 1929 approximately 80 per cent thereof was added between 1916 and 1929, and 70 per cent between 1920 and 1929, a period of uniformly high prices. Certainly, under these facts the historical cost figures were to be viewed as highly indicative of present value.

Furthermore, in 1930, and subsequent thereto, the price trend was definitely downward. This was observed particularly by Circuit Judge Wilbur in his opinion in marking the distinction between the facts in this case and those before this Court in *McCardle v. Indianapolis Water Co.* (1926) 272 U. S. 400. In the latter case it was noted that the Court was dealing with reconstruction cost at a time (1923-1924) when the cost of labor and material was highly advanced over historical cost of the property there considered. Judge Wilbur stated:

> "The Supreme Court in this case (*McCardle Case*) very clearly indicated that where there had been so marked an increase in value over so long a period of time, and likely to continue so long after the time when the rates were fixed, it was necessary to recognize this higher cost in fixing the rate base, and that the historical cost should not be accepted where it was based upon a long period of relatively low cost of labor and material.
>
> *In the case at bar we have the situation exactly reversed. The current rates for labor and material have gradually decreased owing to the depression.*
>
> Prices have depreciated so that at the time of the hearing an affidavit was filed on behalf of the Commission by Mr. Dufour, one of the engineers of the Commission, estimating that the reproduction cost of the Company's property at prices prevailing December 15, 1930, including land at market value as

of December 31, 1929, and excluding difficulty factor is $60,009,099 undepreciated. We quote as follows from the affidavit:

> 'That said figure would represent the cost of the properties as they existed December 31, 1929, if the unit costs and prices prevailing on December 15, 1930, were used, applying overhead charges of six per cent, the average amount actually charged by the Company on its books from 1913 to 1929, inclusive, and including land at market value as of December 31, 1929; that the current price level costs of $60,009,099 as of December 15, 1930, is only $1,321,912 or 2.25 per cent higher than the actual historical cost.'" (R. 146.)

Judge Wilbur emphasized the decline in prices, properly taking judicial notice of the trend of prices and observing:

> "this court will take judicial notice that the costs of reproduction were lessened during the year in which the old rates have been collected by reason of the temporary injunction herein (January 1, 1931, to January 1, 1932). (As to judicial notice see A. T. & S. F. v. Interstate Commerce Commisssion, case No. 287, decided Jan. 4, 1932, 284 U. S. 248.)" (R. 147.)

This Court can properly take judicial notice of the decline in building and material prices which have taken place since the case was submitted before the Commission.[20] (The case before the Commission was submitted in

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20. *A., T. & S. F. v. Interstate Commerce Commission* (1932), 284 U. S. 248; *Lincoln G. & E. Co. v. City of Lincoln* (1919), 250 U. S. 256, 268; *Banton v. Belt Line Rwy. Corp.* (1925), 268 U. S. 413, 422; *Galveston E. Co. v. Galveston* (1922), 258 U. S. 388, 402; *McCardle v. Indianapolis Water Co.* (1926), 272 U. S. 400, 412.

July, 1930; before the lower Court it was submitted in June, 1931, and decided April 8, 1932.)

As an aid to the Court in taking judicial notice of the precipitous decline in prices, reference may be made to standard indices.[21]

The following table showing monthly average index of construction costs from 1913 to 1931 and monthly index for 11 months of 1932, prepared by Engineering News Record,[22] and reported on pages 36 and 37 of the 1932 Annual Supplement, Survey of Current Business, and on page 25 of January, 1933, of Survey of Current Business, published by United States Department of Commerce,

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21. (a) United States Department of Commerce, Bureau of Foreign and Domestic Commerce, Survey of Current Business, 1932 Annual Supplement, pp. 36 and 37, reflecting representative construction cost indices from 1913 to 1931; 1932 prices by months shown p. 25, January 1933 Supplement, Survey of Current Business.

(b) United States Department of Labor, Bureau of Labor Statistics monthly index numbers of wholesale prices; United States Department of Commerce, Bureau of Foreign and Domestic Commerce, pp. 24 to 29, 1932 Annual Supplement of Survey of Current Business and p. 24, January 1933 Supplement Survey of Current Business.

(c) Bradstreet's Average Annual Index of wholesale commodity prices shown in Bradstreet's weekly issue of December 10, 1932, p. 1629.

22. "The construction cost index, computed by the Engineering News Record, is based upon the costs of steel (structural shapes, Pittsburgh base), cement (f. o. b. Chicago, exclusive of bags), lumber (southern pine, New York base), and the rates paid common labor in the steel industry through 1920, after which common labor rates are averages reported from about 20 cities by correspondents of the Engineering News Record. The prices are weighed on the basis of the total production of steel, cement, and lumber, and the total supply of common labor. These index numbers are given as of the 1st day of the month." (p. 289, Annual Supplement 1932, Survey of Current Business, United States Department of Commerce, Bureau of Foreign and Domestic Commerce.)

Bureau of Foreign and Domestic Commerce, is indicative of the decline which has recently taken place. For comparative purposes the index number for recent years is given:

Base 1913=100.

Year	Average Monthly Index	Year	Average Monthly Index
1913	100.0	1931	181.4
1918	189.2	1932 (Monthly)	
1919	198.5	January	162.5
1920	251.3	February	161.8
1921	201.8	March	157.2
1922	174.4	April	153.1
1923	214.1	May	152.8
1924	215.4	June	152.2
1925	206.7	July	153.4
1926	208.0	August	156.8
1927	206.3	September	158.0
1928	206.8	October	159.2
1929	207.0	November	158.2
1930	202.0		

In concluding our discussion of fair value it should be noted again that the Commission was extremely liberal in the treatment of certain items of property. (R. 49, 50.)

(1) As above noted, the artificial gas manufacturing plant, notwithstanding its very doubtful usefulness, was included in each of the valuation estimates of record and included by the Commission in its historical cost rate base figure. In its fair value determination it was recognized by the Commission that the doubtful need of the manufacturing plant had an appreciable adverse bearing upon its value (R. 49, 50);

(2) The Company claimed that all pipe installed prior to 1913 was wrought iron pipe, and the Commission, in its fair value determination, accepted the claim and made

due allowance for such pipe at present day costs. This resulted in a figure of at least $1,500,000 in excess of the price that would have been allowed for steel pipe. (R. 251.) The Commission was liberal in this regard, inasmuch as the evidence was not convincing that wrought iron pipe was in fact installed exclusively prior to 1913. Of seven tests made by the Commission engineer of pipe installed prior to 1913, four proved the pipe to be steel and not wrought iron. (R. 248.) The Company witness included such pipe in his reconstruction cost new estimate because the Company records showed that in pipe purchases before 1913 the Company had specified "wrought iron pipe." The witness made no inspection to determine whether such pipe installed prior to 1913 was in fact wrought iron. (R. 369.)

In view of the fact that the Commission's fair value rate base, exclusive of working cash, materials and supplies and additions for 1930, greatly exceeds the actual cost of the Company's property, and is in excess of its present cost after giving full effect to the present level of prices, including organization and other costs incurred in the development of the business, it is apparent that there is included in said figure a substantial allowance for going concern value. This is particularly evident when the fact is considered that the cost figures and estimates taken, all include the artificial gas manufacturing facilities and other units above discussed.

It is respectfully submitted that the Commission's finding of fair value was reasonable and fully complied with the decisions of this Court. The history of the Fair Value Rule need not be reviewed at any length. In *St. Louis &*

O'Fallon Ry. Co. v. U. S., 279 U. S. 461, this Court found that the principles governing the valuations of a utility property for rate making purposes as expressed originally in *Smyth v. Ames* (1898), 169 U. S. 466, and again in *City of Houston v. Southwestern Bell Telephone Co.* (1922), 259 U. S. 318, have been consistently adhered to by this Court. Undoubtedly the rule requires that consideration be given to present cost as well as actual cost. In *Smyth v. Ames*, it was said that "present" as compared with "original" costs were matters for consideration. In the *Southwestern Telephone Case* it was said that "present costs" must not be disregarded. The Court there states (262 U. S. 288):

> "An honest and intelligent forecast of probable future values, made upon a view of all the relevant circumstances is essential. If the highly important element of present costs is wholly disregarded, such a forecast becomes impossible. Estimates for tomorrow cannot ignore prices of today."

It is equally well settled that the measure of value for rate making purposes is not necessarily replacement or reproduction cost. In *Georgia Ry. & Power Co. v. R. R. Comm.* (1923), 262 U. S. 625, 630, it was said:

> "The refusal of the Commission and of the lower Court to hold that, for rate making purposes, the physical properties of a utility must be valued at the replacement cost, less depreciation, was clearly correct."

As was pointed out in the *Minnesota Rate Cases, Simpson v. Shepard* (1913), 230 U. S. 352, 434, the ascertainment of value is a matter for the exercise of a reasonable

judgment, having its basis in a proper consideration of relevant facts.

Such was the determination of the Commission in the instant case.

ACCRUED DEPRECIATION.

As above pointed out, the Commission's $65,500,000 fair value rate base for 1930 was undepreciated. (R. 43.) The reason for this may readily be explained.

In 1917, in the first decision of the Commission fixing rates for the company, the use of sinking fund depreciation accounting was ordered.[23] The Commission stated:

> "The depreciation allowance made in this case has been determined upon what generally is known as the 6 per cent sinking fund basis. On this basis, in addition to operating expenses, including a depreciation annuity allowance, interest is allowed on the full investment in, or original cost of the property

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23. Under the Public Utilities Act of California, Section 49, the Commission is empowered to prescribe depreciation accounting methods. This section provides:

> "The Commission shall have power, after hearing, to require any or all public utilities to carry a proper and adequate depreciation account in accordance with such rules, regulations and forms of account as the commission may prescribe. The commission may, from time to time, ascertain and determine and by order fix the proper and adequate rates of depreciation of the several classes of property of each public utility. Each public utility shall conform its depreciation accounts to the rates so ascertained, determined and fixed, and shall set aside the moneys so provided for out of earnings and carry the same in a depreciation fund and expend such fund only for such purposes and under such rules and regulations, both as to original expenditure and subsequent replacement as the commission may prescribe. The income from investments of moneys in such fund shall likewise be carried in such fund." Calif. Stats. 1915, pp. 115, 147; Deering's General Laws of California, Act 6386, p. 3523, Sec. 49, p. 3559.)

as distinguished from depreciated value, or cost new less depreciation. On this basis there are two sources from which funds accrue to the reserve to meet replacements or retirements, (1) annual allowance out of operating expenses designated as annuity based on the life of the property, and (2) interest at 6 per cent on the accrued depreciation reserve. The accrued depreciation reserve represents the fund accrued from the above designated sources less retirements from the construction of the plant to date.

In this case the fund has been estimated from the evidence showing the total historical cost of property, average age of different equipment, and estimated average lives.

The annuity which has been allowed as part of the operating expense in determining the total cost of service represents the aggregate of the individual annual amounts which, if set aside each year and invested so as to earn 6 per cent compounded annually, will in each case equal the original cost of the individual items at the end of their estimated lives.

It appears from the evidence in this case that the company has earned and set aside as depreciation reserve an amount in excess of the estimated accrued depreciation based upon the sinking fund basis herein used. It further appears that this amount has been invested in property upon which a return is to be allowed. The company should therefore contribute to the depreciation reserve out of its net return 6 per cent upon the estimated accrued depreciation." (In *Los Angeles Gas and Electric Corp.*, 13 C. R. C. 724, 731, 732.)

In every order issued by the Commission fixing rates for this Company (R. 21), the practice of allowing a

depreciation annuity computed on a 6 per cent sinking fund basis has been followed. The Company has consistently adhered to this method of depreciation accounting. (R. 296A, 296B.) It is admitted (Appellant's Brief, p. 140) that the depreciation reserve has been invested in the properties. This reserve for the depreciable gas capital, as of January 1, 1930, aggregates $9,350,689. (R. 386.)

The use of the sinking fund annuity and the practice of sinking fund depreciation accounting prescribed for the Company are consistent for use with an undepreciated rate base.[24] This is so, inasmuch as the annuity is calculated to return at the end of the expected life, the full original cost or original cost in terms of present day prices, less estimated salvage, through the accumulation of the annuity payments and the compound interest thereon at 6 per cent per annum. Where, as here, the depreciation reserve is invested in the property, the interest on the reserve is annually credited thereto and charged against net income. The annuity is charged to operation and credited to the reserve. The total amount thus credited to the reserve under the fair value setup of the Commission's opinion would be $1,633,041, made up of the annuity allowance of $1,072,000 and the interest on the reserve balance in an amount of $561,041 (6 per cent on balance in reserve of $9,350,689).

Both the Commission and the Company in the proceedings before the Commission presented estimates of the appropriate sinking fund annuity to be used with

24. This rate base may be either original cost or original cost in terms of present day prices.

undepreciated rate bases, it being anticipated that the Commission would adhere to its past practice of fixing rates on an undepreciated base. The Company presented an estimate of $1,222,465 (R. 351), consistent for use with its historical cost estimate. The Commission's witness Wehe showed the sinking fund annuity consistent for use with the historical fixed capital as of December 31, 1929 to be $956,115. (R. 280.) His corresponding annuity figure for use with the full historical rate base for 1930 as found by the Commission was $990,000. (R. 463.) The Commission in its decision, by the application of the same annuity rates to the fixed capital in the higher fair value rate base found (undepreciated), obtained the figure of $1,072,000 to represent the proper sinking fund annuity consistent for use with that rate base. All of the estimates were thus appropriate for use with undepreciated rate bases.

As will presently appear under our discussion of depreciation annuity, these allowances were reasonable and adequate, according to witness Wehe, and were computed on the basis of field inspection and study of past performances of the Company. (R. 289, 463-465.)

The decisions of this Court do not require the use of a depreciated rate base, and we submit that the practice followed by the Commission in this case, and in all previous rate cases affecting this Company, of using an undepreciated rate base and a sinking fund annuity, is fair and reasonable to the utility. Particularly is this true, where, under the state law (Section 49, Public Utilities Act, supra), the Commission has exercised its authority to prescribe sinking fund depreciation accounting practice and

the Company has accumulated a large reserve on this basis. The continuance of the practice heretofore followed by the Commission results in no injustice to the Company.

As was pointed out by the Commission in its opinion, the amount of accrued depreciation is of theoretical rather than actual importance. This is true because the operating results reasonably to be expected from the prescribed rates, when tested on a depreciated fair value base with a consistent treatment of annual depreciation expense, would be almost identical with the result shown in Table No. V of the Commission's opinion (R. 47), on the undepreciated fair value base.

Thus, if the amount of the accrued depreciation found by the Commission to be not less than $7,650,000 (R. 43) is deducted from the undepreciated fair value rate base of $65,500,000, the depreciated fair value base obtained is $57,850,000. A liberal allowance for depreciation annuity, consistent for use with such a rate base, would be not in excess of $1,633,041. This figure represents the total amount to be credited to the depreciation reserve under the rates as fixed[25] and is the maximum figure for depreciation expense that could consistently be used with the depreciated fair value rate base above discussed. It represents the over-all credit necessary to take care of annual depreciation. The fact that this total amount, as an

25. This figure of $1,633,041 is made up of $1,072,000 (R. 47) the annuity on the sinking fund basis, to be charged to operation and annually credited to the reserve, and $561,041, representing the interest on the depreciation reserve balance of $9,350,689, at 6 per cent, the amount to be charged to income and credited to the reserve under the depreciation accounting practice heretofore followed.

annual credit to the reserve, is adequate to cover current depreciation in the properties and is fully supported by the record will be developed under our treatment of depreciation annuity.

With the use of the above discussed fair value base (depreciated) and a consistent treatment of annual depreciation, the result as to rate for return is practically identical with that shown in Table No. V of the Commission's opinion on the undepreciated fair value base. (R. 47.) The following table illustrates this comparison:

	Undepreciated Fair Value Basis	Depreciated Fair Value Basis
Net for Return	$ 4,615,000	$ 4,053,959 [26]
Rate Base	65,500,000	57,850,000
Rate of Return	7%	7.1%

The accrued depreciation of $7,650,000, mentioned in the Commission's opinion as a deductible item from the fair value rate base of $65,500,000, is slightly less than the estimate of witness Wehe, computed by the sinking fund method, with the use of the Commission's reproduction cost new estimate of the properties (overheads on basis charged historically) as a base figure. (R. 257, 288.)[27] With the use of the same age and life estimates (arrived at by observation and not from life tables (R. 289, 304)), the accrued depreciation computed by the

26. This figure of net for return is obtained by deducting from net of $4,615,000 (R. 47), interest at 6 per cent on the depreciation reserve, which interest amounts to $561,041, as above demonstrated. The interest on the reserve, as well as the depreciation annuity, is charged to operation and therefore reduces the net for return by the amount of the interest, under this set-up.

27. That is, $63,827,228 (R. 257) less $7,860,000, for accrued depreciation by the sinking fund method, gives $55,967,228 (R. 288), as the reproduction cost new less depreciation.

straight line method, using the same base would be $15,530,656. (R. 257, 288.)[28]

Appellant in its brief has contended that the rates prescribed should be tested with the use of a straight line depreciation annuity figure on a depreciated rate base. Of course, if this is done, the accrued depreciation to be deducted from the rate base should also be computed on the straight line basis to give a representative result as to rate of return. Thus, for example, if the straight line depreciation annuity of witness Wehe, of $2,306,606 (R. 298), compiled on a capital base of reproduction cost new (with overheads on basis charged historically), is included as an operating expense, the accrued depreciation to be deducted from the Commission's undepreciated fair value base ($65,500,000) would be not less than $15,530,656, the straight line accrued depreciation computed by the same witness on the same base as above developed. By this treatment the projected rate of return to be anticipated from the prescribed rates, when tested against such a depreciated rate base, would approximate the return of 7 per cent shown on the fair value setup in Table No. V of the Commission's opinion. (R. 47.)[29]

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28. That is, $63,827,228 (R. 257) less $15,530,656, for accrued depreciation by the straight line method, gives $48,296,572 (R. 288), as the reproduction cost new less depreciation.

29. $65,500,000 less straight line accrued depreciation of $15,530,656, as computed above, gives a base figure of $49,969,344. Estimated net for return of $4,615,500 shown in Table No. V of the Commission's opinion, less larger deduction for depreciation annuity (straight line figure of $2,306,606 (R. 298) less $1,072,000, sinking fund annuity used in the Commission's opinion) of $1,234,606, leaves a net of $3,380,894. This amounts to a net return of approximately 6.9 per cent upon the above rate base, using straight line accrued depreciation. After making appropriate adjustment for lesser Federal tax on net income, the net of $3,380,894 is increased by $73,902.

The fact that it would be wholly illogical to test the prescribed rates with a straight line depreciation annuity and a rate base depreciated by a sinking fund accrued depreciation figure, was recognized and soundly analyzed by Judge Wilbur in his opinion (R. 162-164), he pointing out that with the use of such an annuity the rate base should likewise be depreciated by a straight line accrued depreciation estimate to produce a representative result. By such consistent treatment it was demonstrated that the rate of return would be substantially the same as shown in the Commission's opinion (R. 47), obtained through the use of an undepreciated fair value base and a sinking fund depreciation annuity.

III. REVENUES.

The gas revenues found by the Commission as reasonably to be expected in 1930 were based upon the estimate presented by the Company's vice-president and executive engineer Masser. His estimate of gross revenue was $16,187,623, based on actual revenues for the first five months of the year and sales for the remaining seven months estimated on normal temperature conditions. (R. 352.) The Commission found that sales normally to be expected during the year were $16,415,000, having adjusted Mr. Masser's estimate for the first five months so as to reflect normal temperature conditions for the entire year. The occasion and necessity for such adjustment may readily be shown.

At the time Mr. Masser submitted his estimate of sales for 1930, he had available the actual revenues received

for only the first five months. He properly assumed that sales for the remaining months would approach those normally to be expected should temperature conditions remain normal. During the first four months of the year temperatures had been greatly higher than normal (R. 336), but for the remainder of the year he necessarily assumed that temperatures would conform to those established over a period of twenty-two years, during which accurate records had been maintained. He conceded that had his estimate for the entire year been based upon normal temperature conditions for each month his estimate of $16,187,623, representing expected revenues for 1930 would have been increased by approximately $227,000. (R. 357.) With that addition, therefore, the Commission accepted his estimate as representative of sales normally to be expected and as a proper basis of testing the reasonableness of the rates fixed for the future.

The Commission's action in that respect was not founded upon the assumption that revenues for 1930 would actually equal the amount used for that purpose. It was attempting merely to adjust accomplished results to a normal basis in order to obtain a foundation for the estimation of normally expected results during the period the rates prescribed should actually be applied. Using also the results of operations for the two preceding years as a guide, the Commission likewise adjusted the actual revenues for those years to a normal temperature basis. The winter months of each year were warmer than normal. The actual effect of the adjustments made may be shown as follows:

Year		Actual Revenues (R. 322, 328)	Adjusted Revenues (R. 26)
1928		$14,839,422	$14,959,000
1929		15,801,208	15,989,000
	Total	$30,640,630	$30,948,000

Thus the difference of $308,000 represents merely the additional sales which the Company might have received had temperatures during the two years conformed to the only standard of normal which may reasonably be accepted. It is true that the year 1930, as well as the two preceding years, was warmer than normal, but that fact does not detract from the equity of the principle adopted. It was properly assumed that unusual temperatures would not continue, either above or below those normally to be anticipated. Whether sales in the past have been depressed or increased because of unusual climatic conditions, no fair estimate of future sales may be made except upon the assumption that normal conditions will prevail.

The Commission did not in any sense estimate revenues for 1930 or for the future upon adjusted sales not in fact experienced in preceding years. It accepted the Company's own estimate of anticipated sales, based upon the number of meters attached and expected sales per meter in the light of adverse business conditions then prevailing, and such estimate was adjusted by the Commission only to reflect normal temperatures for the entire year and reasonably to be expected in the future.

The Company's witness Luick also estimated the volume of gas sales for domestic purposes, based upon the as-

sumption that normal temperatures would prevail. (R. 394a, 395.) He, however, adopted only a ten-year temperature standard. As pointed out by the Commission's witness Guillou (R. 245), had Mr. Luick used the same standard of temperature correction as used by Mr. Masser, his estimate of sales for the year would have been the higher.

The assumption of the Commission and the Company's own witness that future gas sales would equal, but not exceed, those to be expected in a year of normal temperature was entirely proper. The principle was not first applied in this case. It has repeatedly been employed by the Company itself. The history of the temperature correction method and the necessity therefor is given in the affidavit filed by Mr. Kauffman, an engineer for the City of Los Angeles. (R. 490.) Since gas sales, particularly for household purposes, have been shown to bear a very direct relation to climatic conditions, no more equitable method may be devised for the estimation of normal gas sales in the future than by the adoption of the assumption that normal temperature conditions will prevail.

It would not for a moment be contended by the Company that had actual sales in the years used for testing future results been in excess of normal, due to severe climatic conditions, revenues for the future should be based upon the assumption that such conditions would continue. Yet it seemingly argues that because actual sales have been depressed, due to abnormally high temperatures, those sales should be accepted as a standard for the future. Its witness Masser, testifying in respect to the probable demand for gas, declared that he saw

no reason why a mean daily temperature as low as 42 degrees might not be experienced, although at no time since 1909 has such a low mean temperature been experienced. (R. 346.)

The Court was unanimous in approving the Commission's estimate of revenues predicated upon normal temperature conditions. (R. 117, 170, 171.) It quite properly took notice of the fact that the winter of 1931-1932, as it had progressed to the end of January, was the coldest season in many years. It should be noted, also, that it is the temperature condition prevailing during the winter season primarily which is related to gas demand, not the average for the entire year, during a considerable part of which sales for domestic heating purposes are nominal.

The Company in its brief (p. 131) makes reference to the actual temperatures prevailing during 1931, as shown by the records of the Los Angeles Weather Bureau, stating that the average for the year 1931 was 2.1 degrees above the 1926-1930 average, and that during the winter months, when gas sales are greatest, the average for 1931 was .8 of a degree higher than the five-year average.

Had the months of the winter of 1931-32, to the end of January, been compared, the period to which the Court made reference (R. 117), the results would have been as follows:

	22-Year Average (R. 508)	5-Year Average (R. 508)	Actual 1931-1932
November 1931	63.0°	65.6°	58.7°
December 1931	57.6°	59.1°	55.0°
January 1932	56.1°	57.8°	53.3°
Remaining months of 1932 were:			
February 1932	56.9°	58.3°	56.5°
March 1932	58.6°	59.8°	62.2°
April 1932	60.2°	61.2°	62.6°
November 1932	63.0°	65.6°	69.0°
December 1932	57.6°	59.1°	56.6°

It may thus be seen that during winter months (November to April) of the season of 1931-1932, the average temperature was 58.05 degrees, compared to a five-year average of 60.3 degrees and a twenty-two-year average of 58.7 degrees. The inherent reasonableness of the Commission's estimate of sales on a normal temperature basis is thus apparent.

The Commission in its opinion (R. 55) expressed its realization of the fact that future revenues cannot be ascertained with the degree of accuracy desired because of variations in the demand for gas. It, therefore, urged the creation of a reserve for the purpose of equalizing revenues to accord with temperature conditions, a result to be desired by both the Company and its consumers. It offered to it the opportunity of beginning such a reserve fund at the expense of consumers. The Company takes the suggestion lightly. But until such a stabilization plan is devised, the Commission can adopt no method for estimating future revenues more equitable than that which assumes normal temperatures in the future, regard-

less of the fact that during the test period taken actual revenues may have been greater or less than normal.

The opinion of the Commission shows that the Commission in the fixing of rates for the Company gave careful consideration to the current depression and its effect upon sales. In this regard the Commission stated:

> "Since the submission of this case the monthly reports of the Company filed with the Commission show the actual sales for three additional months. Not only do sales show a slight falling off from those estimated for these months, but these monthly reports also show a lesser growth in new meters than was estimated. There is nothing in these reports or in the record to indicate that on a normal temperature basis the Company's business is not growing. The record, however, does indicate that its rate of increase or growth has been perceptibly slowed up. The situation here adverted to calls for and has received careful consideration as showing that the revenue estimates used for 1930 may not be entirely representative, just as the greatly increased operating expense figures used for the year are not entirely representative.
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> "Operating expense also must be assumed to be on a more nearly normal basis than in 1930. Existing business conditions, on the other hand, should be and are given consideration and weight." (R. 51 and 52.)

The Commission also recognized that the reduction in rates would stimulate sales and in a large measure offset any loss resulting from the business depression. (R. 52.)

In the opinion of the Court the following observation was made with reference to the effect of the depression

upon revenues and the consideration given to this matter by the Commission:

> "We therefore hold that there is nothing unreasonable in the estimate of returns by the Commission so far as temperature is concerned, and there is nothing to indicate that due consideration was not given to the possible effect of the depression upon the consumption of gas." (R. 171.)

IV. OPERATING EXPENSES.

Appellant protests the allowance made by the Commission for only two items in its annual expenses of operation, namely, for a fee paid to the Pacific Lighting Corporation, the appellant's holding corporation, and for depreciation.

Excepting these two items, the Commission adopted substantially the estimate for operating expenses submitted by appellant's witness Masser, although production, distribution, commercial and general expenses had been estimated by the Commission's engineer at approximately $540,000 below the corresponding items included by Mr. Masser (R. 34.), and the engineer for the City of Los Angeles urged the reduction of operating expense by not less than $482,000 because of his elimination of the artificial gas plants as a part of the necessary and useful property. (R. 315.)

The actual expenses incurred in preceding years, including the amounts set aside for depreciation, together with estimates for 1930, follow:

OPERATING EXPENSES
Existing Rates

	1928 Actual (R. 322)	1929 Actual (R. 328)	1930 Estimate of Appellant (R. 352)	1930 Used by Commission
Production	$4,490,722	$4,570,377	$4,669,775	$4,612,000
Transmission & Distribution	848,026	786,008	1,103,322	1,123,000
Commercial and New Business	941,155	998,472	998,555	999,000
General and Miscellaneous	700,416	800,286	1,092,507	1,005,000
Uncollectibles	130,057	179,478	182,491	182,000
Taxes	1,545,358	1,632,887	1,632,884	1,637,000
Sub-Total	$8,655,734	$8,967,508	$9,679,534	$9,558,000
Depreciation (charged)	1,115,624	1,143,286	1,222,434	1,072,000
	$9,771,358	$10,110,794	$10,901,968	$10,630,000

Before considering the question of annual depreciation, the other differences between the expense estimates of the Company and the allowances made by the Commission should be noted.

Production Expense.

The Commission's inclusion for this item of expense, consisting almost wholly of the cost of natural gas purchased from producing concerns, was $55,775 less than the estimate of the Company's witness Masser therefor. The Commission's expectancy of gas sales exceeded that of the Company. But its witness applied a price of 17½ cents per thousand cubic feet for all gas to be purchased from the Southern California Gas Company, whereas the actual price as fixed by the Commission for that company (a public utility) was then and has remained only 15½ cents. He stated that the use of the higher rate accounted for a difference of $117,000. (R. 357.) Applying the correct price to anticipated purchases of gas from that

company for 1930 the Commmission correctly estimated production expense to be $4,612,000.

Distribution Expense.

For this item the Commission's allowance exceeded Mr. Masser's estimate by approximately $20,000. The explanation for the increased allowance by the Commission is found in the Company's treatment of overheads. Since its claim of right to adjust capital overheads presupposes a corresponding credit to annual operating expense, its witness acknowledged that on the basis of accounting methods previously followed, operating expenses normally to be included for 1930 would be overstated by $20,000. (R. 352.) The Commmission did not make the same deduction, for it refused to acknowledge either that operating expenses as theretofore accounted for had been overstated or that capital accounts had been understated because of the allocation of overhead charges actually made to these accounts. Although the Commission expressed no objection whatever to the Company's allocation of such charges in 1930 and in the future on any reasonable basis it may select, the Commission did not indulge in the presumption that it would thereafter allocate a greater part to capital and less to expense. Hence it properly included in operating expense an amount commensurate with past expenses and, as testified by the Company's witness, would otherwise be reasonable.

General Expense.

The Commission eliminated entirely a fee of $80,000 paid to appellant's holding corporation. The Commission found that the evidence did not justify its inclusion in the expense allowance. (R. 34.)

There can be no question but that the Commission's treatment of this item was proper. The testimony does not indicate any service rendered to plaintiff by the holding corporation or its officers which is subject to a monetary appraisement of anything like the amount paid. The cost of legal services was given generous allowance elsewhere. And the indefinite aid and counsel claimed to have been given by officers of the holding corporation was certainly no more than might ordinarily be prompted by their financial interest involved.

The supposed services for which this fee was paid have no similarity to those rendered by a utility holding company such as the American Telephone & Telegraph Company to its subsidiaries, which are direct tangible services having an appraisable value, and such as have been held proper expense allowances when their value is proved. The plaintiff made no attempt to show the inherent value of the service rendered by the Pacific Lighting Corporation nor the cost or profit of such service to the latter. This Court has held that the cost to the holding company itself of rendering such services must be proved. *Smith v. Illinois Bell Tel. Co.* (December 1, 1930), 282 U. S. 133, 157.

In *Idaho Power Co. v. Thompson* (1927), 19 Fed. (2d) 547, 575, the three judge Court said concerning a similar fee:

> "In respect to business policy, generally a court will not substitute its own judgment for that of the managing officers of a utility company. This, of course, where the officers act independently and with a view of promoting the interests of the company,

> which normally are not opposed to the interests of the consumers. Manifestly the rule is not applicable where there is common control of both the utility company and the party with whom it contracts."

In *United Fuel Gas Co. v. Railroad Commission* (1929), 278 U. S. 300, 320, it was said:

> "We need not labor the point that a public service corporation may not make a rate confiscatory by reducing its net earnings through the device of a contract unduly favoring a subsidiary or a corporation owned by its own stockholders. Cf. *Chicago & G. T. R. Co. v. Wellman*, 143 U. S. 339, 345, 36 L. ed. 170, 179, 12 Sup. Ct. Rep. 400."

In the *Chicago and Grand Trunk Railway Case* therein cited as authority, the language used was as follows:

> "While the protection of vested rights of property is a supreme duty of the courts, it has not come to this, that the legislative power rests subservient to the discretion of any railroad corporation which may, by exorbitant and unreasonable salaries, or in some other improper way, transfer its earnings into what it is pleased to call 'operating expenses'."

Although appellant's estimate of expense under this group was otherwise accepted by the Commission, it was made clear that certain inclusions therein were items of an unusual and non-recurring nature not furnishing a fair guide to what normal expenses in the future may be. (R. 34.) Extraordinary expenses incident to the valuation of the property and unusual legal expense incurred in the Commission proceeding and in other litigation were included in the 1930 allowance, of which not less

than $200,000 might reasonably have been considered as not to be included in the normal expense allowance. (R. 481-482.)

Depreciation Expense.

The Commission allowed an annual operating expense for depreciation of $990,000 on the historical cost basis and $1,072,000 on the fair value basis. These respective allowances were reasonable and supported by the evidence.

Commission witness Wehe estimated annual depreciation allowance on the basis of the requirements of the Company and a study of the history of the depreciation reserve. The witness stated in his affidavit:

> "The depreciation annuity rates used in Tables II and IV of the Commission's decision were prepared after an exhaustive study into the actual requirements of plaintiff corporation; * * *" (R. 464.)

Table II of the affidavit of witness Wehe states further the relationship (1913-1929) that plaintiff's depreciation reserve bore to the fixed capital for the principal groups of depreciable capital[30] and demonstrated

> "that the reserve is growing at a more rapid rate than the depreciable capital notwithstanding the fact that plaintiff's gas properties (especially mains and services during the last few years) have been subject to extraordinary replacements due to the marked growth in the territory served and because of the

30. The principal groups of depreciable capital are mains, services and meter-regulators comprising 37.38, 13.45 and 9.9 per cent of the depreciable capital, respectively. (R. 289, 292.)

transition from manufactured to natural gas." (R. 465.)

The witness further stated:

"The depreciation reserve exceeds the amount of the accrued depreciation hereinafter found to exist in plaintiff's properties; the annual depreciation expense in the amount of $990,000 for the year 1930 on the historical cost basis (and for other years as shown on Table II of the Commission's Decision) and $1,072,000 for the year 1930 on the present value basis (and for other years as shown in Table IV of said decision) is a liberal allowance and more than sufficient to meet the needs and requirements of plaintiff." (R. 465.)

Life and age of the properties, in so far as they entered into the computations, were determined from inspection of the properties and not from life tables. (R. 289, 304.)

The two annual depreciation estimates used by the Commission were computed on the 6 per cent sinking fund basis and are appropriate for use with the Commission's undepreciated rate base. The $990,000 figure was compiled from a base of the historical cost of the depreciable capital (R. 463, 280) and the $1,072,000 figure exceeds the sinking fund annuity computed by witness Wehe on the Commission's reproduction cost new estimate of the depreciable property, with overheads included on the basis charged historically. (R. 298.) As above demonstrated, under our discussion of current price level cost, this base figure substantially represents book costs converted to the level of present day prices. It may fairly be said, therefore, that the annuity of $1,072,000 was computed on a base figure at least equal to, if not

in excess of the fair value of the depreciable property. It is therefore apparent that the method used in the determination of the annuity on the fair value basis gave sufficient recognition to present day replacement costs and fully met the requirements of this Court announced in *United Railways & Electric Co. v. West,* 280 U. S. 234.

The lower Court upheld the reasonableness of the Commission's allowances for annual depreciation and stated:

> "From the evidence presented, it appears quite clearly that annuity depreciation allowances made prior to the date of the rate hearing here concerned were in excess of what the Company could properly claim. Prior allowances, if excessive, were not controlling. Depreciation was a matter not capable of definite ascertainment, and the Commission had the right to use its judgment under all of the facts displayed before it, aided in weighing the evidence by its experience in dealing with this Company's property and other like utilities, and to adopt a per cent depreciation rather than the amount deducted by the Company. It is not demonstrated by any evidence that the allowance made by the Commission as for depreciation annuity for the future would not, in its amount, be equivalent to the replacement outlay at going costs." (R. 116, 117.)

It is respectfully submitted that the ruling of the lower Court was entirely correct and that the finding is sustained by the record.

In its brief it is argued by appellant that the Commission (and the lower Court) should have tested the rates prescribed, with the use of a depreciation annuity computed by the straight line method. Appellant would then test the revised estimated net revenue against a

depreciated fair value base, arrived at by the deduction of *only* $7,650,000 (slightly less than sinking fund accrued depreciation), from the Commission's undepreciated fair value base. Obviously, such a treatment would be illogical and produce an unfair result. As demonstrated in our treatment of accrued depreciation above, the use of a straight line depreciation annuity in the testing of rates requires that a consistent treatment be given to accrued depreciation and requires that the rate base figure to be used be arrived at by the deduction of such accrued depreciation from the reproduction cost new or current price level cost undepreciated base figure. Thus, as above demonstrated, if a depreciation expense of $2,306,606 is used, the Commission's undepreciated fair value figure of $65,500,000 (in excess of historical cost converted to current level of prices, undepreciated) should be depreciated by the companion figure for straight line accrued depreciation, $15,530,656. The resultant net return obtained by this procedure, as shown above (p. 86 of this Brief), would be approximately 7 per cent, the result projected in Table V of the Commission's opinion by the use of an undepreciated fair value base and a sinking fund depreciation annuity expense.

Not only is the treatment suggested by the appellant (straight line annuity and base depreciated on sinking fund accrued depreciation) wholly illogical, but is unwarranted by the record herein. This is so inasmuch as no witness expressed the opinion that the straight line depreciation annuity figures represented the needs of the Company or that they should be allowed as operating expenses. If, as the Company contends, Mr. Wehe's

straight line annuity must be used with a depreciated rate base, then the adoption of his straight line accrued depreciation estimate must also be used. The use of the straight line method must be consistently applied in determining both the accrued depreciation and the annuity.

The record clearly demonstrates that depreciation (both accrued and depreciation annuity) requires a consistent treatment. Thus witness Wehe testified:

> "I do not feel that the straight line estimate is a correct basis of estimate. It does not represent the value of the property. *The proponents of the straight line method are correct when they say that in a rate case the straight line estimate may be used in estimating accrued depreciation if in setting up the depreciation annuity, a straight line annuity is used. The two must be used together to give a reasonable result.* In my opinion 66 per cent is not the value of that holder to anyone. It represents a mere mathematical relationship.
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> *In a rate case where the estimate of value is reproduction cost new, less depreciation on a straight line basis, in theory you must estimate the depreciation annuity on a straight line basis. On the other hand, the sinking fund annuity would be used with an undepreciated rate base. If depreciation is estimated on a straight line basis, then the annuity should be on the straight line basis.*" (R. 293.)

It should be noted that Company witness Luick expressed the opinion that $1,300,000, or about 2 per cent of his reproduction cost estimate, was proper for depreciation expense. (R. 385.) He stated that the contingency reserve, that is, the present depreciation reserve of $9,350,689, less his estimate of $3,470,326 for accrued

depreciation, when built up to about $12,000,000, then further accumulations should cease, for the interest alone on such reserve ($720,000 annually) would take care of all annual replacements. There would then be no occasion for further annual allowance for depreciation expense. (R. 390.) If this be so, then the sum of $720,000 per annum is now sufficient to take care of all replacements. This is proof sufficient that the Commission's sinking fund depreciation expense allowance of $1,072,000 was more than ample to meet the depreciation requirements of appellant.

The Commission witness Wehe in fact computed his depreciation expense estimates with unusual liberality. What the Commission may have included in the past for this item is not determinative of a reasonable expense today. Mr. Wehe in his affidavit before the Court (R. 462-468) showed that appellant's present depreciation reserve has been growing at a more rapid rate than its depreciable capital, notwithstanding the fact that its properties (especially mains and services during the last few years) have been subject to extraordinary retirements due to rapid expansion and public requirements. (R. 297.) In fact, Mr. Wehe was attempting to provide an insurance expense to care for all functional depreciation, obsolescence on supersession which might occur. However, in computing actual accrued depreciation, he did not attempt to measure the functional factor beyond that observed, and thus he obtained rates of depreciation considerably less than used in computing depreciation expense. He testified that had he computed depreciation expense on the same basis taken for his

estimation of actual accrued depreciation, he would have obtained a greatly reduced annuity. (R. 298).

In concluding our discussion of depreciation annuity it should be emphasized that the depreciation expense allowance of $1,072,000, made by the Commission in fixing rates on the fair value basis shown in its opinion (R. 47), does not represent the total annual credit to the depreciation reserve. The annuity was computed on the sinking fund basis and in conformity with the depreciation accounting practice prescribed for this Company in 1917 and consistently adhered to since that date.[31]

The Company will, therefore, credit to its depreciation reserve of $9,350,689, interest at 6 per cent per annum, which for the first year under rates prescribed will be $561,041. The total amount credited to the depreciation reserve at the end of the year would be $1,633,041, made up of the annuity of $1,072,000 (to be charged to operation) and interest on the balance in the reserve, $561,041 (to be charged to income).

We have demonstrated above (pp. 84-85, this Brief) that substantially the same result (7 per cent return) is obtained by the use of a fair value rate base (Commission finding of fair value of $65,500,000 undepreciated, less accrued depreciation found by the Commission to be not less than $7,650,000) of $57,850,000, charging the total $1,633,041 (interest on the balance in depreciation reserve and annuity) to operation, as is obtained by the use of the undepreciated fair value rate base set up in the Commission's opinion, under which the annuity is charged to

31. This point was developed at length hereinabove, pages 80-82.

operation and the interest on the balance in the reserve charged to income.[32]

It is thus apparent that on any logical view of the case the Commission's allowance for expense of depreciation was reasonable, fully supported by the record and properly approved by the lower Court.

V. RATE OF RETURN.

The Company claims that any rate prescribed yielding a return of less than 8 per cent on the fair value of its property would be confiscatory. Its witnesses testified that the return should be substantially over 8 per cent. Such opinion testimony, founded mainly on the hypothesis that the average return on the capital invested in other business undertakings in the City of Los Angeles, attended by corresponding risks and uncertainties, had been, and will for a reasonable period of time in the future, be not less than 8 per cent per annum.

The Commission offered evidence showing the rate at which this utility, and other comparable utilities, had been able to obtain their capital. The record contained abundant evidence pertaining to the rate which this utility and others are able to obtain their capital, evidence which shows conclusively, we submit, the high appraisement accorded by investors to the securities of such utilities and

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32. Thus with the use of the fair value (depreciated) base and a consistent treatment of depreciation expense (charging to operation, interest on balance in depreciation reserve, as well as the annuity) shows a net for return of 7.1 as compared with 7 per cent shown on the fair value (undepreciated) base used in the Commission's opinion. (R. 47.) (See p. 85, this Brief, for breakdown of these figures.)

their willingness to invest capital in undertakings of that class. In *Bluefield Waterworks and Improvement Co. v. Public Service Commission of W. Virginia* (1923), 262 U. S. 679, 692, it was said:

> "What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties."

But the language of this Court, just quoted, is not the whole of the rule for determining the legal rate of return, in so far as any rule or formula has been announced. In the same case it was said further:

> "* * * but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time, and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally.
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> * * * * * * *
>
> Investors take into account the result of past operations, especially in recent years, when determining the terms upon which they will invest in such an

> undertaking. Low, uncertain, or irregular income makes for low prices for the securities of the utility and higher rates of interest to be demanded by investors. The fact that the company may not insist as a matter of constitutional right that past losses be made up by rates to be applied in the present and future tends to weaken credit, and the fact that the utility is protected against being compelled to serve for confiscatory rates tends to support it."

What may be a reasonable rate of return for a given utility at one time may, then, be unreasonable at another time because of changed conditions affecting investment of such enterprises. Innumerable factors influence an investor when considering the placement of capital in one business or another, but there is no basis upon which the risks and uncertainties of one business can be accurately balanced with those attending another. It is proper that the Commission and the Court below should have preferred to base their judgment upon what this and other comparable utilities have actually done in the way of maintaining and supporting their credit rather than upon the opinion of witnesses concerning the comparative attractiveness of investments in other and unrelated business undertakings.

The Company's witness Rosetti, after testifying that the minimum fair rate of return would be from 8½ to 9 per cent (R. 430), stated on cross-examination that he did not know at what rate the Company had actually been able to finance its enterprise. And, as illustrative of his attitude toward utility investments generally, he testified (R. 431) that he considered a public utility stock, irrespective of the return today, a poor purchase. Mr.

Sinsheimer, also for the Company, testified (R. 440) with almost equal bias, that a utility which regularly pays dividends on its common stock of 10 per cent, and at the same time has something over to add to surplus, would still have difficulty over a period of time in obtaining money to make capital extensions.

Such testimony, of course, is wholly at variance with the actual facts, as revealed in the history of this utility. The Commission, referring in its opinion to the growth of the Company, stated (R. 22):

> "This remarkable growth has been financed largely by the sale of the Company's bonds and preferred stock, these having been marketed at a gradually lessening cost, so that the present annual cost of its bond and preferred stock money is 6.17 per cent. Also, its depreciation reserve has been invested in the property. If this be included with its bond and preferred stock money at the rate of 6 per cent, being the rate at which it is required to account for its reserve, the annual cost of its bond, preferred stock and depreciation reserve money is but 6.14 per cent. On December 31, 1929, the Company had outstanding in the hands of the public" (referring to both the gas and electric departments) "$47,070,000 par value of bonds, $19,469,995 par value of preferred stock, and $20,000,000 par value of common stock. Its depreciation reserve on that date was reported at $16,804,105.15. All of its common stock is owned by Pacific Lighting Corporation. Since 1916 but $4,500,000 of this stock has been purchased for cash, $5,500,000, however, having been distributed to Pacific Lighting Corporation in the form of stock dividends, representing earnings left in the property. Dividends have been paid on its common stock of 7.20 per cent per share ($100 par value) in 1916,

1917 and 1918; 7.4 per cent in 1919; 8.4 per cent in 1920, 1921 and 1922; 8.7 per cent in 1923; 33.75 per cent in 1924, included in which is 25 per cent as a stock dividend of $2,500,000; 9 per cent in 1925; 9.815 per cent in 1926; 35.17 per cent in 1927, which includes a stock dividend of 21.42 per cent, or $3,000,000; 15 per cent in 1928, and 17 per cent in 1929. The Company's surplus has grown from $381,212.97 in 1916, to $4,176,663.09 in 1929, while its depreciation reserve increased from $3,804,383.36 to, as said above, $16,804,105.15."

In spite of that record of growth, the burden of the Company's claim now is that the rate of return which was enjoyed in the past is insufficient, and that the return prescribed for the future is confiscatory.

The fact that the risks and uncertainties of the Company are nominal in comparison with ordinary business ventures is demonstrated throughout this record. We have in large part answered the Company's claim of a hazardous business in our treatment of the Company's "Gas Manufacturing Plant".[33]

It is obvious that regulatory bodies cannot be controlled by "off-hand testimony of financiers concerning the general cost of money for similar enterprises" (Judge Wil-

33. It is interesting to note the inconsistencies of the Company with reference to the "hazards" of its business. Its witness Luick in testifying with reference to going concern value emphasizes "exceptionally good history of growth * * *, an established business, with satisfactory record of earnings and excellent future prospects." (R. 393.) In its brief the Company states "It" (Company) "is efficiently and economically operated. Its earnings (within any limits here involved) are subject to no commercial limitations and only to the restriction imposed by law that it will not be permitted to earn an excessive return on the fair value of its property." (Company Brief, p. 101.)

bur R. 177), particularly where such witnesses liken the risks and uncertainties of a sound successful public utility enterprise to the risks and uncertainties which an investor takes in investing in ordinary industrial and business ventures, or in making real estate loans. The Commission, familiar with the history of this utility as revealed throughout the record and having regard for all relevant facts, could not, in the exercise of a fair and enlightened judgment, be expected to accept without reservation the testimony of the Company witnesses as to the fair rate of return.

The Court may properly take judicial notice of the hazards incident to ordinary real estate loans, industrial and business ventures, just as it may take such notice of the current economic depression and the present decline in commodity prices.[34] Certainly the risks and uncertainties assumed by investors in embarking in such undertakings cannot be likened to those assumed by investors who purchase the securities of this and like public utility companies. Here we are considering a utility that has enjoyed a history of good earnings (R. 24), under regulation by a Commission that has granted many increases in rates. (R. 21.)

The lower Court in treating the subject of rate of return was clearly warranted in holding:

> "If the experience of the Company under regulation has been, as the Commission finds, that returns have exceeded estimates, then it may well be that its

34. *Atchison, Topeka & Santa Fe v. Interstate Commerce Commission* (1932), 284 U. S. 248; *Lincoln G. & E. Co. v. City of Lincoln* (1919), 250 U. S. 256, 268; *Banton v. Belt Line Railway Corp.* (1925), 268 U. S. 413, 422.

net will be greater than the per cent allowed under the last rate schedule. With a history of successful and profitable business, and no real competition to meet in its field of service, the hazard is small and the probabilities of continued demand assured. Electricity has not to any great extent supplanted gas as a fuel. All of the conditions noted, as affecting the business of the Company, sustain the Commission in its statement that the plaintiff's securities are capable of being marked at moderate interest rates, and that it will continue to grow.

"The Company produced two witnesses having familiarity with financial investment conditions, who testified that risks and uncertainties of the business considered, the Company should earn more than 8 per cent on the fair value of its property. The Commission was correct in saying that it was not to be controlled by this testimony in the face of facts before it. It cannot be said that, assuming the reasonableness of the base amount used, the rates prescribed would not produce a fair return." (R. 111.)

"The Company insists that the evidence requires a finding that 8 per cent is a reasonable rate of return upon the fair value of its property, but we cannot sustain this contention. The question of the percentage of return upon a public utility depends to a large extent upon the hazard as well as the current price of money which also varies with the hazard. We do not accept the testimony of financiers that 8 per cent represents the rate of return upon 'similar' enterprises, for the fact is that there are no similar enterprises except other gas companies and electric companies operating in California under the jurisdiction of the California Railroad Commission whose rates are fixed in the same manner as those of the plaintiff." (R. 174.)

"We have a unique situation in California, for all such companies are under the jurisdiction of one rate-making body, the Railroad Commission. As these corporations have been successfully operated and financed for nearly 20 years under its supervision and have extended their operations and increased their capital in conformity with the rulings of the State Railroad Commission, it would seem to follow that the income allowed by the Railroad Commission as return upon the money invested would be a better test of what constitutes a reasonable return than the off-hand testimony of financiers concerning the general cost of money for similar enterprises." (R. 177.)

The actual experience of the Company in financing its business will next be shown.

COST OF MONEY.

Cost of money, as the term is commonly used, is simply the annual cost or charge against the utility's net income because of fixed interest and preferred dividend requirements. The annual cost of capital obtained from the sale of bonds and preferred stock is a fixed charge against income to be met before the payment of dividends on the common stock. The rate paid for that capital directly reflects the opinion of investors in the stability of the business as well as the prevailing rate of return upon capital investments of that class. No such measure obtains for the return demanded by the common stock investor. If his return is commensurate with that of other investors, and such return is assured, then the financial soundness of the utility is apparent and it may continue to raise the money necessary for the discharge of its

public utility duties. The rate of dividend actually paid on the common stock does not measure its cost.

The Company has financed both its gas and electric business as a single unit. In June 1929 it had outstanding in par values, $47,121,000 bonds, $19,418,700 preferred stock, and $20,000,000 common stock. (R. 231.) It apportions its capital between the two departments on the basis of 60 per cent to gas, 40 per cent to electric. (R. 374.) To determine the cost of capital invested, however, no prorations need be made.

Mr. Fankhauser, the head of the Commission's Department of Finance and Accounts, found that (R. 233) after providing for the amortization of the discount and selling expense, in addition to the annual interest charge, the effective interest rate on the net proceeds obtained from the sale of the Company's bonds is 5.96 per cent. The effective dividend rate on its preferred stock is 6.72 per cent, the effective rate on bonds and preferred stock combined is 6.17 per cent, computed as follows:

Bond Proceeds	$44,341,480 × 5.96% =	$2,643,090
Preferred Stock Proceeds	17,330,317 × 6.72% =	1,164,597
Total	$61,671,797 × 6.17% =	$3,807,687

Mr. Fankhauser testified also that the Company's depreciation reserve of $15,685,277 as of the same date should be taken as a part of its borrowed capital, inasmuch as the Commission has calculated depreciation on a 6 per cent sinking fund basis. If this is included with the bond and preferred stock money, the effective interest rate on that total capital is 6.14 per cent. (R. 233.)

The computation as made by the witness (R. 233) is as follows:

A. Bond Proceeds	$44,341,480.97 × 5.96%	=	$2,643,090.30
B. Preferred Stock Proceeds	17,330,317.50 × 6.72%	=	1,164,597.34
C. Depreciation Reserve	15,695,277.11 × 6.00%	=	941,116.63
Total	$77,367,075.58	6.14%	$4,748,804.27

The Company's witness Houghton attempted to show the cost of bond money to be 6.40 per cent, and that of preferred stock money 6.76 per cent. His cost of bond money was based upon the costs of eighteen different issues since 1899, eight of which have since matured or been redeemed. (R. 425.) Some of the issues now retired bore a nominal interest rate of 7 per cent. No issue presently outstanding bears a nominal interest rate of more than 6 per cent, and the present average nominal interest rate is 5.47 per cent. (R. 236.) Mr. Houghton's study reflects the cost of borrowed capital, the net proceeds from which total $55,462,369 (R. 425), whereas, the net proceeds from presently outstanding bond issues are only $44,341,480. (R. 236.) Obviously, no purpose is served in developing the cost of security issues long since retired. The whole purpose of the inquiry into the cost of the Company's capital is to ascertain the reasonable return upon its invested capital today. It is evident that the present annual interest and dividend rate paid on its bond and preferred stock money is only 6.17 per cent.

It readily may be seen that had Mr. Houghton excluded from his computation (R. 424) the bond issues which have since been retired, his weighted average cost of bond money, including bondholders tax paid by the Company and annual trustee fees, would have been considerably less than the average of 6.40 per cent. Without the interest on tax and fees, the cost of presently outstanding bonds obtained by his method of computation would have

been 6.02 per cent, and including such tax and fees, would have been 6.12 per cent.[35]

Mr. Fankhauser did not estimate the cost of the Company's common stock. It has not been sold to the public or traded upon any exchange. (R. 235, 485.) Its market value is unknown. Some of it was issued for property, the cash value of which cannot be determined. (R. 484.) Stock dividends have been declared in the amount of $5,500,000. (R. 233.) There is, therefore, no basis for the estimation of its cost. Mr. Fankhauser testified that it might be disposed of as readily and at about the same price as the common stock of the Pacific Gas and Electric Company and the Southern California Edison Company, both of which are on a lower dividend basis. (R. 233-235.)

If it were assumed that the return upon common stock investments of this class is 8½ per cent, then the average of the Company's total interest and dividend demands is 6.62 per cent, computed as follows:

Bond Proceeds	$44,341,480 × 5.96=	$2,643,090.30
Preferred Stock Proceeds	17,330,317 × 6.72=	1,164,597.34
Common Stock Proceeds	20,000,000 × 8.50=	1,700,000.00
Depreciation Reserve	15,695,277 × 6.00=	941,116.63
	$97,367,074 × 6.62=	$6,448,804.29

35. Issues numbered by Mr. Houghton as Nos. 1, 2, 5, 6, 7, 8, 11 and 17, as he shows (R. 425), have been retired. Had he included only the outstanding issues in his computation (R. 424), the totals of Columns 3 and 5 from which his percentage is derived, would have been, respectively, $330,941,318 and $19,946,322, and the resultant average cost would have been 6.02 per cent. Including in Column 5 the bondholders' tax and trustee fees, the resultant percentage would have been 6.12 per cent. Trustees fees are included as an operating expense and are not properly to be included in cost of bond money.

Company witness Sinsheimer testified that the Company should obtain a return of approximately one per cent over and above the cost of money invested in the property, as a so-called margin of safety, which should be sent to surplus annually. (R. 437.) If one assumes his cost of money with margin of safety to be correct and applies it to his total of invested capital of $81,000,000, (par value of outstanding bonds, preferred and common stock of Company) there would remain for surplus annually $799,410. (R. 484.) Considering the experience of the Company and the contingencies covered by insurance, the premium of which is included in operating expenses, there is no necessity for an annual addition to the Company's surplus of $799,410.[36] The Company on December 31, 1929, had an accumulated surplus of $4,176,663, which surplus would have been $9,676,000 had the Company not declared stock dividends of $5,500,000. (R. 485.) Continued additions to surplus in the amount shown are unnecessary. Every contingency is provided for by other reserves. This building up of surplus for the purpose of increasing common stock capital upon which the Company may in turn claim the right to equal dividends is simply a building up of its capital at the expense of the consumers. The policy followed by this Company in declaring stock dividends and thereby reducing its accumulated surplus demonstrates that its management does not believe in the necessity of constantly increasing the surplus account.

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36. An analysis of the annual reports which the Company has filed with the Commission from 1913 to 1929, shows the total amount charged to profit and loss for the entire period, other than dividends, to have been $860,362.55. (R. 484.)

Authorities on rate of return.

In *Smith v. Illinois Bell Tel. Co.* (Dec. 1, 1930), 282 U. S. 133, 160, this Court said:

> "In determining what is a confiscatory regulation of rates, it is necessary to consider the actual effect of the rates imposed in the light of the utility's situation, its requirements and opportunities. As was said in *United Railways v. West,* 280 U. S. 234, 249, 250, a rule as to the rate of return can not be laid down which would apply uniformly to all sorts of utilities; 'what may be a fair return for one may be inadequate for another, depending upon circumstances, locality and risk.' "

When in 1919 this Court, in *Lincoln Gas Co. v. Lincoln* (1919), 250 U. S. 256, considered the question of what is a reasonable return, it took judicial notice of the fact that the return upon capital and enterprise the world over had materially increased since the war, and said, at page 268:

> "* * * what would have been a proper rate of return for capital invested in gas plants and similar public utilities a *few years ago* furnishes no safe criterion for the present or for the future."

Therefore, those cases decided even a few years ago are not now controlling. A rate order confiscatory when made may cease to be so at a later time. *Smith v. Illinois Bell Tel. Co., supra.* Having recognized changing economic conditions in the past necessitating higher rates of return, the Court should now be equally prompt to recognize changing conditions resulting in a lowering of the return on capital and enterprise.

During what may be termed the pre-war period, a 6 per cent return was not considered confiscatory.

Willcox v. Consolidated Gas Co. (1909), 212 U. S. 19;

Des Moines Gas Co. v. Des Moines (1915), 238 U. S. 153;

Denver v. Denver Union Water Co. (1918), 246 U. S. 178.

In the *Lincoln Gas Case, supra,* decided in 1919, this Court, though it apparently considered a 6 per cent return insufficient under the changing conditions, did not expressly hold such a return confiscatory. In the same year, in *Ohio Valley Water Co. v. Ben Avon Borough,* 253 U. S. 287, a 7 per cent return for a water company was approved. In 1922 it was said that a 7½ per cent return on a gas property cannot be deemed confiscatory, *Georgia Ry. & Power Co. v. Railroad Comm.,* 262 U. S. 625, although in the same term holding that 6 per cent for a water company was too low under the circumstances. *Bluefield Water Works v. Public Service Comm., supra.* In another water company case decided in 1926, it was said that a reasonable rate of return is not less than 7 per cent. *McCardle v. Indianapolis Water Company,* 272 U. S. 400.

It was held in the recent case of *Wabash Valley Elec. Co. v. Young,* decided by this Court January 9, 1933, that a return of 7 per cent allowed by the State Commission for an electric company was not confiscatory.

The return of a utility, such as the one here seeking to have the rates prescribed by the State Commission held confiscatory, is one of the most stable of all business un-

dertakings. Such a utility can scarcely be said to suffer the risks and uncertainties of other unrelated enterprises. If the rate of return of the utility is to be measured by the return obtained upon capital invested in other undertakings, certainly a return of even less than 7 per cent is not today confiscatory.

THE LESSENING COST OF CAPITAL.

The Commission in its opinion states:

> "The present actual annual cost to the Company for its bond and preferred stock money is 6.17 per cent. However, just as the assumption that the Company's property was constructed at prices now current increases the actual cost figure, so a similar assumption that the Company was financed on the basis of current money cost or value would reduce the figure of 6.17 per cent to 5.46 per cent.[37] If the Company is to derive the advantage due to economic changes which raise the value of its property over its actual cost, it should at the same time in fairness expect to suffer any detriment due to economic changes which may lessen the cost or earning ability of money." (R. 50-51.)

From Mr. Fankhauser's exhibit showing the cost of the Company's bond and preferred stock money (R. 236, 238) it may be seen that the effective rate for recent issues has materially decreased. The Commission properly took notice of the lessening cost of money to the comparable utilities above mentioned. (R. 20.) Reference may be made also to more recent orders of the Commission authorizing the issuance of securities by these utili-

37. Before the lower Court it was conceded by the Commission that due to a typographical error this figure should have been 5.64.

ties; on December 10, 1930 (35 C. R. C. 569) for the sale by the Southern California Edison Company of $5,000,000 refunding mortgage 25-year 4½ per cent bonds at not less than 95 (effective rate 4.85), and on January 10, 1931 (35 C. R. C. 695), for the sale by the Pacific Gas and Electric Company of $25,000,000 refunding 30-year 4½ per cent bonds at not less than 95 (effective rate 4.80).

The tables in Mr. Fankhauser's exhibit (R. 233-234) evidence the ability of these comparable utilities in recent years to sell to the public their common stocks on which the established dividend rate of 8 per cent is less than that enjoyed by the owner of the stock of appellant Company. (R. 233.) The evidence in the record shows that the Company also might dispose of its common stock as readily and upon practically the same basis as have the Southern California Edison Company and Pacific Gas and Electric Company (R. 235), and the risks and uncertainties of the Company do not materially differ from the risks and uncertainties which an investor takes when he buys the securities of these comparable utilities. (R. 485.) In respect to the common stock of the Company owned by the Pacific Lighting Corporation, it may be observed that the Southern California Gas Company, whose common stock is also owned indirectly by the Pacific Lighting Corporation, was authorized by the Commission on February 16, 1931 (35 C. R. C. 837), to sell to its parent company $3,000,000 par value common stock on a dividend basis of 7½ per cent.

EARNING POSITION OF THE COMPANY.

In what has been stated above in respect to the cost of the Company's capital and its ability to obtain capital

at current prices, there has been no attempt to make a segregation between its gas and electric departments. Such a segregation must necessarily be made in a most arbitrary manner because funds have not been obtained or investment made with any distinction between the two departments in mind.

Mr. Luick stated that the Company is presently apportioning 60 per cent of its total capital to the gas department. (R. 374.) Mr. Fankhauser stated in his affidavit (R. 487) that the Company's report for the twelve months' period ending October 31, 1930, showed an apportionment of 60.3 per cent to the gas department and 39.7 per cent to the electric department. If the latter higher ratio of apportionment is applied to the Company's annual fixed interest and dividend charges, as was done by Judge Wilbur in his concurring opinion (R. 121-122), the net earning position of the Company under the rates fixed by the Commission may be plainly shown as follows:

Annual Bond Interest	$2,643,090 × 60.3% =	$1,593,783
Annual Preferred Stock Dividend	1,164,597 × 60.3% =	702,252
Interest on Depreciation Reserve ($15,695,277 × 6%)	941,116 × 60.3% =	567,493
Total Annual Charge		$2,863,528
Total Net Revenue (R. 47)		$4,615,000
Net Return available for Common Stock Dividends		$1,751,472
Rate of Return on Common Stock ($20,000,000 × 60.3% = $12,060,000)		14.5%

It is submitted that the gas rates fixed by the Commission are, by every test, not only non-confiscatory but just and reasonable.

"Capital's invitation is alluring, and this corporation experienced no difficulty in securing its capital requirements. * * * A 7 per cent. return will amply assure capital and reward investors." (*New York Telephone Co. v. Prendergast* (1929), 36 Fed. (2d) 54, 69.

Conclusion.

The question presented in this case is whether the rates prescribed by the Commission will necessarily have the effect of depriving the Company of its property without due process of law. The California Commission, specially constituted and qualified to fix the rates of public utilities, has, after a full hearing, fixed rates declared to be just and reasonable for this utility. The District Court, in passing upon the issues there presented as to the validity of the Commission's order, has declared that no constitutional right of the Company has been invaded. Every presumption, therefore, is in favor of the validity of the Commission order, and the findings and decree of the lower Court.

In *San Diego Land & Town Co. v. National City* (1899), 174 U. S. 739, 754, this Court expressed the principle in the following language:

"But it should also be remembered that the judiciary ought not to interfere with the collection of rates established under legislative sanction unless they are so plainly and palpably unreasonable as to make their enforcement equivalent to the taking of property for public use without such compensation as under all the circumstances is just both to the owner

> and to the public; that is, judicial interference should never occur unless the case presents, clearly and beyond all doubt, such a flagrant attack upon the rights of property under the guise of regulations, as to compel the court to say that the rates prescribed will necessarily have the effect to deny just compensation for private property taken for the public use."

The record before the Commission and the District Court was full and complete. The proceeding before the Commission was not an initial rate proceeding for this Company. It has been under regulation for many years. Facts pertaining to the cost of its property and the actual results of its operations under regulation are known. Estimates and conclusions as to the results to be obtained in the future must have their basis in past experience, and the Commission's estimates are based upon known results in past years.

The Commission valued the Company's property only after giving full consideration to every element of value claimed. The fair value accorded was fair and reasonable when judged by accepted standards laid down by this Court. Although the Company's properties were constructed in large part during the decade from 1920 to 1930, when prices were appreciably higher than have prevailed during the past two or three years, the Commission accorded to the properties a value considerably in excess of such cost. The fair value determination of the Commission reflected the present value of the property and a successful going business.

The anticipated revenues were those to be expected under normal temperature conditions. The number of

gas meters expected to be attached were those estimated by the Company itself, as well as its estimate of volume of sales per meter, corrected only to reflect temperature conditions normally to be anticipated. In this regard the practice followed was substantially the same as pursued by the Company and the Commission in past rate cases. That the effect of the current depression upon sales and revenues was carefully considered by the Commission has been demonstrated above.

Operating expenses likewise were in greater part those presented by the Company itself based upon its own claim of continued growth. The disputed items, mainly that for depreciation, received the Commission's careful consideration and its conclusions thereon are fully sustained by the evidence in the record. The operating expense allowance of the Commission was liberal.

The net return to the Company under the rates prescribed of at least 7 per cent upon the present value of its property, and 7.7 per cent upon its actual cost, is a reasonable rate of return and in no sense confiscatory of the Company's property. Under such a return the Company may continue to retain the confidence of investors, to obtain adequate capital for continued growth, and to pay at the same time more than reasonable profits to its owners. It is a rate of return equal to that received for other comparable utilities within the State of California which, like this Company, have grown and prospered and been able to obtain adequate capital for every needed development.

It is respectfully submitted that the record fully supports the findings and decree of the lower Court. There-

fore, its decree dismissing the bill of complaint and upholding the Commission, should be affirmed.

Dated, San Francisco, California,
January 25, 1933.

ARTHUR T. GEORGE,
IRA H. ROWELL,
RODERICK B. CASSIDY,
Counsel for Appellees.

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In the Supreme Court

OF THE

United States

October Term, 1932.

LOS ANGELES GAS AND ELECTRIC CORPORATION,
Appellant,

vs.

RAILROAD COMMISSION OF THE STATE OF CALIFORNIA, et al.,
Appellees,

CITY OF LOS ANGELES,
Intervener.

BRIEF FOR INTERVENER

Statement of the Case

Appellant, Los Angeles Gas and Electric Corporation,[1] is a subsidiary of the Pacific Lighting Corporation, a holding company. (R. 22.) It is engaged in the furnishing of gas and electricity to the cities of Los Angeles, Pasadena, South Pasadena, Alhambra, Huntington Park,

(1) The Los Angeles Gas and Electric Corporation will be referred to as the Company, the Railroad Commission as the Commission, and the City of Los Angeles as the City. All emphasis is ours unless otherwise indicated.

Inglewood and surrounding territory. It is the successor of former companies which started in 1867 in the City of Los Angeles and has grown and prospered equally with the growth and prosperity of this section of Southern California. (R. 416.)

Prior to 1927 the Company manufactured its gas from oil (R. 416); shortly before 1927 it was using a mixture of natural gas and artificial gas, but since 1927 the Company has been on a straight natural gas basis. It receives its natural gas from certain transmission companies, including the Southern Counties Gas Company and the Southern California Gas Company, both of which are also subsidiaries of the Pacific Lighting Corporation. (R. 225.) These companies procure the natural gas from the many fields surrounding the Los Angeles territory, including what are known as the Los Angeles Basin Fields, immediately adjacent to the territory; the Santa Barbara and Ventura Fields, approximately 100 miles from the said territory; and, more recently, from the Kettleman Hills Field, which is one of enormous productivity, distant approximately 225 miles from the Company's distribution system. (R. 307.)

It was in evidence before the Commission that the cost of this gas delivered to the Company's system was 15½c to 17½c per m.c.f. (R. 357.) Under the rates in effect prior to the investigation by the Commission the Company was permitted to charge consumers, under Schedule No. 1, 80c for the first 300 cu. ft. or less per meter; and for all over, 72½c per m.c.f. Under Schedule No. 2, 80c for the first 300 cu. ft. or less per meter; and for all over, 77c per m.c.f.

The difference in these schedules was based upon the districting of the territory, the city's rate being the lower

rate. The Commission, after an exhaustive hearing lasting in excess of twenty-three trial days, reduced these rates as follows: Schedule No. 1, for the first 300 cu. ft. per meter the rate was left as it existed, at 80c; for the next 3700 cu. ft. it was reduced to 69c per m.c.f., a reduction percentage of 4.83; for all over 4000 cu. ft. the rate was prescribed at 59c per m.c.f., a reduction of 18.62%. Schedule No. 2, the first 300 cu. ft. per meter was also left at 80c; the next 3700 cu. ft. was reduced to 73c per m.c.f., a reduction of 5.19%; and all over 4000 cu. ft. was reduced to 63c per m.c.f., a reduction of 18.18.%. (R. 4.)

It was in evidence before the Commission that the financial structure of the Company (including both gas and electric properties) was as follows (R. 231):

Bonds	$47,121,000
6% Preferred Stock	19,418,700
Common Stock[1]	20,000,000
	$86,539,700

The Commission considered various valuation estimates as of December 31, 1929, of the Company's property, including: historical cost with overheads at different figures; current price levels with different difficulty factors; and reproduction cost new with different difficulty factors. (R. 39.) And these estimates were also considered by the Commission depreciated upon both the sinking fund and straight line bases. Upon these estimates the Commission found a present fair value rate base of $65,500,000 for the year 1930 (R. 45); it found actual historical cost of $60,704,000 (R. 26); considered carefully

(1) Entirely held by Pacific Lighting Corporation. (R. 239.)

reproduction cost new upon the various considerations set forth and that claimed by the Company and arrived at present fair value of $65,500,000 upon all the estimates and bases considered. This, however, was undepreciated. The Company claimed the accrued depreciation upon its gas properties did not exceed $3,470,326 (R. 37), which is less than 3½% of the reproduction cost new set up by the Company of $99,237,677 (R. 37). The Commission said such accrued depreciation was not less than $7,650,000 (R. 43), which is 7.7% of the reproduction cost new ($99,237,677) claimed by the Company; 12.6% of its historical cost ($60,704,000); and 11.7% of present fair value ($65,500,000).

Going concern value was claimed by the Company in the sum of $9,228,667 (R. 40); and other large intangibles claimed by the Company were: Cost of financing $5,921,470; promoter's remuneration $2,500,000; and overheads of 24.27%, which the Commission refused in part to allow, pointing out that these intangibles amounted "in the aggregate to $33,472,202, a sum equal to more than 50% of the claimed direct replacement cost of the physical property." (R. 37.)

The Commission also found that the Company's own reproduction cost figure for tangibles was $65,765,480 (R. 37), and this figure included many items in dispute. Among these items were: (a) overheads; (b) whether pipe purchased prior to 1913 was wrought iron or steel (R. 50); (c) accrued depreciation (R. 37); and (d) inclusion in the rate base of the Company's gas manufacturing plants (R. 49).

We mention these facts before proceeding with our argument, as appellant's statement of facts apparently

ignores many of these vital factors. As appellant states in its brief (p. 11) that both the Company and Commission engineers were "quite in harmony" as to the historical cost of the properties and that "the final results differed by less than 5% in amount," the entire case resolves itself, upon analysis, to the inquiry regarding intangibles, i. e., (a) did the Commission fix a confiscatory rate in failing to include in the rate base intangibles claimed by the Company upon a theoretical reproduction cost new basis? and (b) is the Company entitled to a greater rate of return than 7% upon a fair value basis of its property in the sum of $65,500,000?

In the following argument we will attempt, as far as possible, to meet the specific points made by appellant and the order of counsel's argument will be followed.

As to the Jurisdiction of This Court

The City alleged in its answer as an affirmative defense that plaintiff had a plain, speedy and adequate remedy at law, in that Section 67 of the *Public Utilities Act of the State of California* (Stats. 1915, p. 115)[1] provided for a review of the Commission's decision by the

(1) The material portions of said Section 67 are as follows:

"Within thirty days after the application for a rehearing is denied * * * the applicant may apply to the Supreme Court of the State for a writ of certiorari * * * for the purpose of having the lawfulness of the original order * * * on rehearing inquired into and determined. * * * No new or additional evidence may be introduced in the Supreme Court but the cause shall be heard on the record of the Commission as certified to by it. The review shall not be extended further than to determine whether the Commission has regularly pursued its authority, including a determination of whether the order or decision under review violates any right of the petitioner under the Constitution of the United States or of the State of California. The findings and conclusions of the Commission on questions of fact shall be final and shall not be subject to review; such questions of fact shall include ultimate facts and the findings and conclusions of the Commission on reasonableness and discrimination. * * * Upon the hearing the

Supreme Court of the State by writ of certiorari. (R. 100.) The Company merely petitioned the Commission for rehearing and upon its denial it filed its bill of complaint for injunctive relief in the District Court of the United States.

Appellant has cited for its authority, in this connection, the cases of—

Los Angeles Railway Corporation v. Railroad Commission, 29 Fed. (2d) 140;
Wilcox v. Consolidated Gas Company, 212 U. S. 19;
Oklahoma Natural Gas Co. v. Russell, 261 U. S. 290;
Prendergast v. New York Teleph. Co., 262 U. S. 43; and
Railroad Commission v. Duluth Street Ry. Co., 273 U. S. 625.

The more recent ruling of this court in *Lehigh Valley R. Co. v. Public Utility Commissioners of the State of New Jersey*, 278 U. S. 24, raises some question as to whether or not appellant exhausted its remedies at law before appealing to the federal courts.

Section 67 of the *Public Utilities Act*, which we have heretofore set forth, was construed in *Napa Valley Electric Co. v. Railroad Commission*, 251 U. S. 366, wherein this court said:

" * * * The applications for writs of certiorari were denied (by the California Supreme Court),

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Supreme Court shall enter judgment either affirming or setting aside the order or decision of the Commission. * * * No court of this state (except the Supreme Court to the extent herein specified) shall have jurisdiction to review, reverse, correct or annul any order or decision of the Commission, or to suspend or delay the execution or operation thereof, or to enjoin, restrain or interfere with the Commission in the performance of its official duties; provided, that the writ of mandamus shall lie from the Supreme Court to the Commission in all proper cases."

> which was tantamount to a decision of the court that the orders and decisions of the Commission did not exceed its authority or violate any right of the several petitioners under the Constitution of the United States or of the State of California."

In referring to this case and quoting the citation above set forth, this court said (in the *Lehigh Valley R. Company* case):

> "But, if, for any reason, that remedy, as defined in those decisions, should not be available or be inadequate, it would seem to be clear that resort might then be had to the court of chancery. In Allen v. Distilling Co. of America, 87 N. J. Eq. 531, 100 Atl. 620, the court of chancery in New Jersey used this language: 'So long as courts of equity are to serve the purpose of the creation of the court of chancery of England * * * jurisdiction must depend only upon the existence of, or a threatened, wrong, *and the absence of an adequate remedy at law.*' * * * Due to our habit of endeavoring to find decided cases to fit each situation, we too often overlook the fundamental reasons for the creation or evolution of the court. It received no grant of express powers nor were express duties imposed upon it. The law courts were left to deal with the violation of all rights for which they could give an adequate remedy. The duty of relieving against any remaining wrongs was imposed upon the court of chancery."

However, in *Railroad Commission v. Duluth*, 273 U. S. 625, Mr. Justice Holmes, speaking for the court, held that it was unnecessary to exhaust state remedies before appealing to the federal courts, as that requirement is not a fundamental principle of substantive law but merely one of convenience or comity.

In *Prentis v. Atlantic Coast Line Co.*, 211 U. S. 210, this court specifically held that the state action must be exhausted before application can be made to the federal courts, and that such action in the state courts is not *res judicata.*

We maintain here, under the latest utterance of this court, that plaintiff is seeking injunctive relief without having first exhausted its remedies at law as provided by the statute itself.

Scope of Examination by This Court

As a foreword, we take for granted that this court "will not review determinations of the Commission made within the scope of its powers, or substitute their judgment for its findings and conclusions." (*United States v. New River Company*, 265 U. S. 533.) And that "this court has no concern with the correctness of the Commission's reasoning, with the soundness of its conclusions, or with the alleged inconsistency with findings made in other proceedings before it." (*Virginian R. Co. v. United States*, 272 U. S. 658.) And that "if the determination of the Commission finds substantial support in the evidence, the courts will not weigh the evidence nor consider the wisdom of the Commission's action." (*Chicago R. I. & P. R. Co. v. United States*, 274 U. S. 29.) And, as Mr. Justice Brandeis, in his dissenting opinion in the case of *St. Louis & O'Fallon R. Co. v. U. S.*, 279 U. S. 461, says: "On the contrary, findings of the Commission involving the appreciation or effect of evidence have been treated with the deference due to those of a

tribunal 'informed by experience' and 'appointed by law' to deal with an intricate subject."

Illinois C. R. Co. v. Interstate Commerce Comm., 206 U. S. 441.

Appellant also states (p. 31):

"* * * that the lower court did not afford the Company the 'independent judgment as to the law and the facts' which under the law and the decisions of this court it is its duty to give in cases of this character."

The general rule is that the determination of an administrative commission is conclusive on the courts if it acts within its statutory powers, and its action is neither fraudulent nor arbitrary.

In *Moffatt Tunnel Imp. Dist. v. Denver & S. L. Ry. Co.*, 45 Fed. (2) 715, at page 732, it was said:

"* * * But in any event, the law is clear that the determination of an administrative commission is conclusive on the courts, if it acts within its statutory powers, and its action is neither fraudulent nor arbitrary. United States v. Mackintosh (C. C. A. 8) 85 F. 333; Whitcomb v. White, 214 U. S. 15, 29 S. C. 599, 53 L. Ed. 889; Chicago, B. & Q. Ry. Co. v. Babcock, 204 U. S. 585, 27 S. Ct. 326, 51 L. Ed. 636; United States v. Budd, 144 U. S. 154, 12 S. Ct. 575, 36 L. Ed. 384. This general rule is buttressed by the provisions of the statute, for the very section which imposes these duties upon the Commission, concludes with the mandate that 'the judgment and action of the Board on all matters referred to in this section shall be final except as specifically in this act limited.'"

In *United Fuel Gas Co. v. Railroad Commission*, 13 Fed. (2d) 510, affirmed 278 U. S. 300, it was said (at page 525):

> "The burden of showing such confiscation rests upon complainants. The evidence of confiscation must be clear, before the court would be justified in holding the action of the Commission to be unconstitutional. The rate will not be set aside unless the evidence compels conviction that a fair-minded board would not have reached the conclusion that the rate would not prove adequate. The initial presumption is in favor of adequacy and this presumption must be clearly overthrown by evidence before a permanent injunction will issue. See San Diego Land & Town Co. v. National City, 174 U. S. 739, 754, 19 S. Ct. 804, 43 L. Ed. 1154; San Diego Land & Town Co. v. Jasper, 189 U. S. 439, 442, 23 S. Ct. 571, 47 L. Ed. 892; Knoxville v. Knoxville Water Co., 212 U. S. 1, 17, 29 S. Ct. 148, 53 L. Ed. 371; Van Dyke v. Geary, 244 U. S. 39, 49, 37 S. Ct. 483, 61 L. Ed. 973; Galveston Electric Co. v. Galveston, 258 U. S. 388, 401, 402, 42 S. Ct. 351, 66 L. Ed. 678."

ARGUMENT

I. Value of the Property

Historical Overheads

Appellant's first point is that the Commission fixed an historical rate base "$2,000,000 less than the amount shown by the evidence of its own engineers" and "the 'fair value' rate base was $10,000,000 less than the cost of reproduction shown by the evidence of its own engineers,—in each case without including any sum for

going value." (Br. pp. 45-46.) On page 49 of its brief appellant states: "The discrepancy between the figure so fixed and the minimum evidence as to historical cost (amounting to more than $2,000,000 for the fixed properties alone) arises primarily from the amount included in the book record of additions and betterments from 1916 to 1929." And that "the amounts recorded by the Company on its books in respect of indirect construction cost or overheads were *inadequate* to reflect the proper amount of these costs."

The Company further contends that the Commission did not make a proper allowance for the item of overheads. Overheads of 6.35% were allowed by the commission for the reason that any sum expended over that item was by the Company charged to operating expenses and has been paid for by the consumers.

The Company takes a most inconsistent position in this, that it argues that the actual experience of the Company is the best guide in determining the net revenue which will be derived by the Company (Br. 126, et seq.), but is no guide at all in determining what is proper to be allowed as overheads. (Br., 49, et seq.) The Company argues that the historical cost of the properties of the Company, as shown by its books and records, is not in fact an historical cost at all, but that to that sum there should be added a sum which, in the opinion of the engineers, could have been charged to capital. (Br. 52.)[1]

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(1) Appellant states (p. 52): "One of the steps required (to determine historical cost) is to determine the correct overhead percentages to be applied to the direct labor and material items shown in the inventory, in order to arrive at the total cost. This percentage is determined from the books, records and other pertinent data, **AND IS MORE ACCURATE THAN THE AMOUNTS ACTUALLY APPEARING ON THE BOOKS**, as representing such overhead items, entered at the time."

It must be borne in mind that the Company was content to charge to capital a sum slightly less than 6% as overheads (R. 270), and any other sum which was expended for this item was charged to operating expense and paid for by the consumers. It appears to us that it would be unjust and inequitable now to permit the Company to take advantage of its own wrong, so to speak, and charge to capital an item which has been previously charged to operating expense in order to increase its rate base, which would necessarily increase the rates for service which it would be permitted to charge.

The Company, in support of its contention that the Commission did not allow proper overheads, has cited the case of *Monroe Gaslight & Fuel Co. v. Michigan Public Utilities Commission*, 292 Fed. 139 (Br., pp. 50 and 63), which we submit is no authority at all in support of the Company's contention. In that case the court said (p. 148):

> "* * * The only evidence before the Commission was the report of its own engineers, who, both as to reproduction cost and original cost, made this estimate of about 14 per cent. The only additional evidence before the court is that of the utility's engineers, who testify that the proper allowance is about 20 per cent. If, perchance, the Commission had in mind evidence or papers in other cases, or general documents in its files which showed that 14 per cent was too high, it had no right to base its findings on such documents or evidence without calling them to the attention of the utility and giving it a chance to be heard."

The Company cannot rightfully contend that it should be permitted to charge this item to both operating and capital.

In the case of *Natural Gas Co. v. W. Virginia Public Serv. Comm.* (1924), 95 W. Virg. 557, 121 S. E. 716, the court said (p. 722):

> "We are of opinion that in any estimate of the present fair value of the company's property, based upon reproduction cost new, less depreciation, there may properly be included in such estimate a reasonable allowance for 'overhead charges,' if such charges have not already been paid as operating expenses, but the evidence as to the amount is too uncertain in this case for us to determine any particular sum. Upon further inquiry the Commission can ascertain such amount as may be warranted by the evidence, and that sum, when so found, may be given such weight, along with the other facts relevant to the inquiry, as the Commission may deem proper. *But no allowance for overhead costs should be made where they have already been paid by the public as operating expenses.* The utility should not be permitted to capitalize such overhead charges and require the public to keep on paying a return on expenses already repaid the utility. If, however, it should be found that actual expenditures have heretofore been made for overhead costs which have not been charged to and paid as operating expenses, allowance should be made therefor."

In the case of *City of Minneapolis v. Rand*, 285 Fed. 818, which was an action brought for the purpose of enjoining the enforcement of an ordinance fixing rates to be charged for gas distributed by the utility, the court approved the rejection by the master of an allowance

for overheads for the reason that "all items of overhead and all expenditures made to create going value have been charged to the operating expense account of the company from 1870 to 1914 and paid from the earnings, and that if these charges were paid, the net earnings of the company were excessive and more than a fair return on the capital investment, and that there was no attempted public regulation of the earnings of the company until 1910." In that case the court refused to disturb the findings of the master.

Also, in the case of *United Fuel Gas Co. v. Public Serv. Comm.*, 14 Fed. (2d) 209, which was an action brought for the purpose of enjoining the enforcement of an order and decision of the Public Service Commission of the State of West Virginia fixing and establishing rates to be charged for gas, in reference to the matter of overheads, the court said:

> "* * * The writer of this opinion had on another occasion to give some consideration to the great discrepancy there almost always is between what the experts, in making up a reproduction cost, estimate must be expended for overheads and the sums the particular utility actually laid out for such purposes. Chesapeake & Potomac Telephone Company of Baltimore City v. Whitman (D. C.), 3 Fed. (2d) 947, et seq.
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> "A well-managed public utility almost always builds up an organization which, as a part of its every day work and without appreciable additional cost, can and does superintend the making of such additions and extensions as from time to time may be required. The possession of such a staff is not the least important asset going to make up what is

called going concern value. *Perhaps one of the reasons why reproduction cost, although one of the weightiest elements in the determination of present fair value, is not necessarily controlling, is the very fact that, in arriving at it, the experts always include an expenditure for overheads far in excess of any which the utility ever incurs.*"

We agree with appellant's statement (Br., p. 44) "that in determining the confiscatory character of rates prescribed by state authority for public utility companies the basis of all calculation is the present fair value of the property devoted to public service." We do contend, however, that any sum in excess of 6.35% which has been incurred for overhead costs was by the Company charged to operating expenses and paid for by the consumers.

Upon these peculiar facts, the cases cited by appellant to support its claim that overheads can now be increased and placed in the rate base have no application.

Reproduction Cost

Appellant (Br., pp. 72 to 92) complains that the Commission did not give due consideration to reproduction cost and that the court below "approved the methods used by the Commission, and, like the Commission, refused to consider the evidence of cost of reproduction." (Br., p. 80.)

As we have heretofore pointed out in our statement of facts, the Commission did consider the Company's estimate of reproduction cost. However, it was not adopted by the Commission as the basis for arriving at its conclusions as to the present fair value of the prop-

erty, apparently for the reason that the Company's claims were so exaggerated that little, if any, weight could be given thereto. As pointed out by the Commission in its decision, the Company claimed a total value of $99,237,677 in its estimate of reproduction cost new, from which sum there should be deducted the sum of $3,470,326 as accrued depreciation, leaving the present value of the property ascertained on a reproduction cost new basis of $95,767,351, of which sum the intangibles amount to $33,472,202. (R. 36-37.) We are of the opinion that this fact alone is sufficient to justify the action of the Commission in rejecting the Company's claims.

Appellant contends that the Commission's order and decision is erroneous for the reason that it failed to consider evidence of reproduction cost. We contend that the Commission did consider the evidence of reproduction cost new of the plant and equipment. Part II of the Commission's order and decision is devoted exclusively to a discussion of the Company's contention that it is entitled to earn a return on the estimated reproduction cost new. (R. 36.)

We contend that the estimated reproduction cost is only *one* factor to be considered by the Commission in arriving at a rate base or in fixing the fair value of the property of the utility.

Smyth v. Ames, 169 U. S. 466;
Los Angeles Ry. Corp. v. Railroad Comm., 29 Fed. (2d) 54;
Kansas City So. Ry. Co. v. United States, 19 Fed. (2d) 591;

New York Tel. & Tel. Co. v. Prendergast, 36 Fed. (2d) 54;

Georgia R. & Power Co. v. Railroad Comm., 262 U. S. 625;

Minnesota Rate Cases, 230 U. S. 352.

In the case of *Georgia R. & Power Co. v. Railroad Commission,* supra, which was an action brought for the purpose of enjoining the enforcement of an order and decision of the Railroad Commission of the State of Georgia fixing rates for gas supplied to the consumers thereof by the Georgia R. & Power Company, the court said (pp. 629, 630):

> "The case is unlike *Missouri ex rel. Southwestern Bell Teleph. Co. v. Public Serv. Commission,* No. 158, decided May 21, 1923, (262 U. S. 276, ante, 981, 43 Sup. Ct. Rep. 544). Here the Commission gave careful consideration to the cost of reproduction, but it refused to adopt reproduction cost as the measure of value. It declared that the exercise of a reasonable judgment as to the present 'fair value' required some consideration of reproduction costs as well as of original costs, but that 'present fair value' is not synonymous with 'present replacement cost,' particularly under abnormal conditions. That part of the rule which declares the utility entitled to the benefit of increases in the value of property was, however, specifically applied in the allowance of $125,000, made by the commission to represent the appreciation in the value of the land owned. The lower court recognized that it must exercise an independent judgment in passing upon the evidence; and it gave careful consideration to replacement cost. But it likewise held that there was no rule which required that, in valuing the physical

property, there must be 'slavish adherence to cost of reproduction, less depreciation.' It discussed the fact that, since 1914, large sums had been expended annually on the plant; that part of this additional construction had been done at prices higher than those which prevailed at the time of the rate hearing; and it concluded that, 'averaging results and remembering that values are * * * matters of opinion * * * no constitutional wrong clearly appears.'

"The refusal of the commission and of the lower court to hold that, for rate making purposes, the physical properties of a utility must be valued at the replacement cost, less depreciation, was clearly correct. As was said in Minnesota Rate Cases (Simpson v. Shephard), 230 U. S. 352, 434, 57 L. Ed. 1511, 1555, 48 L. R. A. (N. S.) 1151, 33 Sup. Ct. Rep. 729, Ann. Cas. 1916A, 18:

" 'The ascertainment of that value is not controlled by artificial rules. It is not a matter of formulas, but there must be a reasonable judgment, having its basis in a proper consideration of all relevant facts.'

"What these relevant facts are had been stated in Smyth v. Ames, 169 U. S. 466, 546, 547, 42 L. Ed. 819, 849, 18 Sup. Ct. Rep. 418."

The case of *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U. S. 276, 67 L. Ed. 981, was an action brought for the purpose of enjoining the enforcement of an order and decision of the Public Service Commission of the State of Missouri fixing and establishing rates to be charged for telephone service. In that case Mr. Justice Brandeis and Mr. Justice Holmes, in their concurring opinion, stated as follows (pp. 295, 296):

> "Obviously, 'value' cannot be composite of all these elements. Nor can it be arrived at on all these bases. They are very different, and must, when applied in a particular case, lead to widely different results. The rule of Smyth v. Ames, as interpreted and applied, means merely that all must be considered. What, if any weight, shall be given to any one, must practically rest in the judicial discretion of the tribunal which makes the determination. Whether a desired result is reached may depend upon how any one of many elements is treated. It is true that the decision is usually rested largely upon records of financial transactions, on statistics and calculations."

It is interesting to note that in the rate proceedings held before this Commission, which concluded with the order and decision reported in 32 C. R. C. 379, the Company claimed the value of its property, as of January 1, 1928, estimated on a reproduction cost new basis, to be $64,363,650, and that in two years the Company claimed the value of its property, as of December 1, 1929, estimated on the same basis, to be $77,586,700, and during the two-year period the additions and betterments which were added to the property did not exceed the sum of $2,750,000. (R. 39.)

Appellant argued in the court below that reproduction cost ordinarily is to be given *dominant* weight in determining present fair value. It now argues that the Commission "gave no weight or consideration to the evidence of reproduction cost. * * *" (Br., p. 74.) We think any fair construction of the Commission's decision shows conclusively that reproduction cost new was fully considered but rejected in part for the reasons above stated.

We also contend that the actual finding of present fair value in this proceeding was one based upon conflicting evidence and is purely a matter of fact decided adversely to appellant, so far as its additional claim went, both by the Commission and by the three-judge statutory court below, and unless a substantial question of law is raised here is not reviewable by this tribunal.[1]

Going Value

One of the largest claims of the Company for intangibles is the separate item of $9,228,667 for going value. As this sum is predicated historically upon fixed property claimed by the Company in the sum of $63,413,246 (App. Br., p. 46), it would appear that the percentage so claimed would approximate 15%. A question is seriously presented whether so-called "going concern value" can be claimed at all in a rate proceeding. The McCardle case cited by appellants seemingly so holds. However, this court in a later case (*United Fuel Gas Co. v. Railroad Commission*, 278 U. S. 300), affirmed the ruling of the court below (13 Fed. (2d) 510), wherein the court said:

> "The fallacy of this argument, that, because of the earning capacity and large return allowed, the property has greatly increased in value, and that such increased value should thereupon be taken as the basis for another calculation of a still larger return, would seem quite apparent. The fallacy of valuing the use upon the earning capacity, and then

(1) Akron, Canton & Youngstown Ry. Co. v. U. S., 261 U. S. 184. (The New England Divisions case), Mr. Justice Brandeis stating: "To consider the weight of the evidence, or the wisdom of the order entered, is beyond our province."

fixing rates upon the value thus determined, has been observed by Mr. Justice Hughes in the Minnesota Rate Cases, 230 U. S. 352, 461, 33 S. Ct. 729, 57 L. Ed. 1511, 48 L. R. A. (N. S.) 1151, Ann. Cas. 1916A, 18, and by Mr. Justice Brandeis in his concurring opinion in the Southwestern Telephone Co. case, supra. See, also, the following cases, to the effect that earning power, in the sense of good will or franchise value, must be excluded from consideration in arriving at the rate base: Wilcox v. Consolidated Gas Co., 212 U. S. 19, 52, 29 S. Ct. 192, 53 L. Ed. 382, 15 Ann. Cas. 1034, 48 L. R. A. (N. S.) 1134; Cedar Rapids Gaslight Co. v. Cedar Rapids, 223 U. S. 655, 669, 32 S. Ct. 389, 56 L. Ed. 594; Des Moines Gas Co. v. Des Moines, 238 U. S. 153, 165, 35 S. Ct. 811, 59 L. Ed. 1244; Galveston Electric Co. v. Galveston, 258 U. S. 388, 396, 42 S. Ct. 351, 66 L. Ed. 678; Georgia Railway v. Railroad Commission, 262 U. S. 625, 632, 43 S. Ct. 680, 67 L. Ed. 1144."

And in the case of *Galveston Electric Company v. Galveston*, 258 U. S. 388, the court stated:

"In determining the value of a business as between buyer and seller, the good will and earning power due to effective organization are often more important elements than tangible property. * * * And they, like past losses, should be considered in determining whether a rate charged by a public utility is reasonable * * * but in determining whether a rate is confiscatory good will and franchise value were excluded from the base value in Cedar Rapids Gaslight Company v. Cedar Rapids, 223 U. S. 655, and Des Moines Gas Company v. Des Moines, 238 U. S. 153, * * * and the expressions in Denver v. Denver Union Water Company, 246 U. S. 178, 184,

191, 62 L. Ed. 649, 658, 661, P. U. R. 1918C, 640, 38 Sup. Ct. Rep. 278, and in Lincoln Gas & E. L. Co. v. Lincoln, 250 U. S. 256, 267, 63 L. Ed. 968, 976, 39 Sup. Ct. Rep. 454, are not to be taken as modifying in any respect the rule there declared. *Going concern value and development cost, in the sense in which the master used these terms, are not to be included in the base value for the purpose of determining whether a rate is confiscatory.*"

Whitten, Valuation of Public Service Corporations (2nd Ed., 1928, revised by Wilcox), Ch. 29, Vol. II, reviews these authorities at length, and clearly indicates that the courts have frequently failed to note this distinction in allowing going value in rate cases. He says (at p. 1351):

> "This discussion of (going) value for public purchase obviously does not apply with the same force to fair value for rate-making. * * * These are the very elements—good will and earning power—that are largely determinative of value in a purchase case, as Mr. Justice Brandeis clearly stated in Galveston Electric Co. v. Galveston, 258 U. S. 388, where he distinguished between public purchase and rate-making."

In the court below, in the Galveston case, 272 Fed. 147, Judge Hutcheson had this to say of going value:

> "In short, when 'going concern' is stripped of its involvment and obscurity, its attractive names and titles, it presents itself, on the one hand, where the past record of the utility has been profitable, as nothing more than good will, which the courts have always refused to allow; and, on the other hand, where the past record has been unprofitable, as

nothing more than an effort to capitalize errors and misfortunes, as to the impropriety of which the decisions of the Supreme Court are equally clear. The confusion which has resulted in this matter is that which springs from the failure to distinguish the essential principle involved in these rate controversies; that a utility is entitled to earn on its property a fair return, and that the rates can neither be increased, on the one hand, by the fact that the Company has enjoyed a profitable business, nor decreased, on the other hand, by the fact that its business has been unprofitable, either because of the lack of support of the utility by the people of the community, or of any other untoward features which would gravely affect the company if its property were valued for the purpose of bargain and sale. * * * In short, the real question here is the value of the plant in operation, and this value should be the same for rate-making purposes, whether its past history has been successful or unsuccessful."

The California Railroad Commission, in *In re Pacific G. & E. Company*, P. U. R. 1923C, 385, in refusing to allow going value, had this to say:

> " * * * If the right or the ability of a given property to earn a certain return is of value, the right or ability to earn a larger return is certainly of greater value. The inclusion of this going value in the rate base increases the amount of return, which must increase the going value, which will still further increase the return, again increasing the going value, and we thus find ourselves in an ascending spiral approaching infinity as a limit."

It would seem to us that the proper rule should be that no going concern value should be allowed in the

fixing of rates to be charged by public utilities, for such an item is an intangible and whether characterized as "good will" or an effort "to capitalize errors and misfortunes," or as "earning power," the fact remains that, as Judge Hutcheson said in the *Galveston* case, supra, "the real question here is the value of the plant in operation"; and the utility which generally enjoys a monopoly should not be permitted to capitalize property not used and useful in the public service, but which only becomes of value in the event of the sale of the business.

As an economic principle, can it be said that any other businesses are so operated? Does a large department store, because of its being a going concern, charge its customers a premium on their purchases? We find, generally, that the contrary is true. On the other hand, however, if the department store is sold and has a record of past earnings as a going concern, there is a value in such an instance which the purchaser will pay over and above the "bare bones" of the enterprise.

Furthermore, since the basic, fundamental theory of public utility regulation tends to result in monopolistic control of the service, should the regulatory body and the courts allow the same business that is granted such a monopoly to exact further tribute from the consumer of a commodity that is necessary and essential to his welfare, and for which there is no other practical substitute, simply because he is a consumer and has no other alternative?

Regardless of what it is called, going value is, in the main, an attempt to capitalize losses, or the inability of the property to pay a return on the money invested in the early stages of development. From a standpoint of

reasonableness and equity between the owners of the property today and the rate-payers of today, there is no good reason why the public should be forced to pay rates that will pay the present owners a profit on an increased investment, purely because the owners in the early stage of the development of this property may have failed to get a fair return on their money. It certainly is discrimination to make the rate-payer today, and for all time in the future, pay a profit to the present owner based upon the assumption that rate-payers in the past did not carry their portion of the burden. If this were proper equity, it would be just as logical to penalize the owners by establishing a rate that would pay only a meagre return after it was proven they had for some period, been collecting rates that paid a return on the value of their property used and useful to the public far in excess of what is ordinarily considered fair and reasonable. Of course, the owners in a case of that kind would claim confiscation or the taking of property without due process of law.

Mr. Luick attempted to justify going concern value and arrived, in the final analysis, at approximately the same figure at which Mr. Miller arrived, by the method of estimating the value to the owners of a customer.

His estimate was that the cost of acquiring a customer is approximately $10.00 (R. 396). If the owners were in a business that was competitive, there might be some basis to this argument, but the very fundamentals of public utility regulation immediately eliminate competition.

Considering further, the exigencies of the local situation show there has been no other practical substitute

for gas in the past, and the small prospect of any substitute being available in the near future indicates that every inhabitant of Southern California is not only a potential gas consumer, but is, of necessity, a gas consumer due to the lack of any equal substitute, when gas can be obtained.

If this is the case (as we believe it is), then certainly the expenditure is not great in order to induce a person to purchase a commodity of which the Company has a monopoly; dispenses not only what the consumer wants, but what he is forced to buy. If, by law, the owners are allowed to increase their capital investment by reason of having customers to purchase a commodity that is necessary and essential to the welfare of the community as a whole (the same law allowing them the exclusive and sole monopoly of dispensing that commodity), then only one interpretation of the situation can be visualized, viz., that the law regulating the operation of public utilities, originally drafted for the purpose of protecting the public, as well as the owners of the utility, against cut-throat competition, has been perverted to the extent of penalizing the public for being a customer, when it has no alternative.

"Going value" has received considerable attention by the courts and various commissions, and no absolute rule has been laid down.

We feel quite strongly that this court should give further consideration to this point in order that the apparent ambiguity in the rulings referred to may hereafter be avoided by regulatory commissions.

Going Concern Value Was Allowed

The Commission treated its cost as a current operating expense. (R. 41-42.) The opinion of the court below stated that "the large amounts claimed by the Company for cost of financing, $5,921,470; promoter's remuneration, $2,500,000; cost of attaching business (going concern value), $9,228,667; added 'difficulty' costs, $580,195, we think were properly rejected as for their total amounts. * * * Basically, the object of an appraisement for rate-making purposes is to find the full value of the investment in the business. The investment is represented by the value of the property used and necessary in the business—not what it would cost to promote and establish a like business starting today." (R. 117.)

The concurring opinion of Circuit Judge Wilbur, although holding that going concern value existed, ruled, in effect, that the rate fixed by the Commission was not confiscatory because of the inclusion by the Commission of approximately $11,000,000 in the rate base represented by the manufacturing or standby plants, which offset the exclusion of whatever should have been allowed for going concern value not in excess of that claimed by the Company, in the sum of $9,228,667. (R. 153.)

We desire also to point out to the court that in fixing present fair value at $65,500,000, the Commission allowed $18,650,000, representing accrued depreciation (at least $7,650,000) and gas plants not used and useful in the public service ($11,000,000), which could have been, with equal propriety, deducted; which in effect, as Mr. Justice Wilbur points out, is more than compensatory for an allowance for going concern value, promoter's remunera-

tion and cost of financing claimed by the Company (R. 152).

A further argument also is based upon the fact that the historical cost of the property, as found by the Commission, was $60,704,000 (R. 47) and the fair value fixed was $65,500,000, or a difference of about $5,000,000 over and above the so-called "bare bones" of the enterprise.

Appellant argues in its brief (p. 206) that were the gas plants eliminated from the rate base, the charge for amortization thereof over a ten-year period would exceed the depreciation and the return on the plant if it remains in the rate base. However, this could only be upon an historical basis for, as the evidence shows, the manufacturing plants are totally inadequate to serve the present needs of the Company; have produced no substantial quantities of gas since 1927; that if they did produce gas it would not burn in the consumers' appliances unless all such appliances were readjusted for the lower quality gas; and, lastly, that the supply of natural gas is more than adequate for domestic purposes for many years to come. (R. 317-318.) So, if we assumed the theoretical reconstruction program set forth by the Company, it would have no necessity to build any such plants at all until the available supplies of natural gas became lower than the domestic requirements. The industrial use of the gas is of little consequence as industry turns to natural gas in preference to oil, electricity or other fuels, only because of its cheapness.

The Company argues that the plants act as a standby plant so that in the event of breaks in the transmission lines at least *some* gas will be available. This argument, however, was based upon conflicting evidence before the

Commission and before the court below, and the Commission and the court both found, in effect, that the plants were not needed as standby plants. (R. 32, 49, 152.)

In this connection, we desire to point out to the court that the evidence before the Commission and the court below showed that the Company's system was literally surrounded by transmission lines bringing in natural gas from every point of the compass, and that in the event of a break in one line there were many others to rely upon. (R. 307-311.)

It was also shown that it would take considerable time to put the standby plant (even though hot) upon a producing basis (R. 343); that the gas produced would be utterly inadequate to supply the peak demands of the consumers, regardless of whether the consumers could use the gas without adjustment of their appliances (R. 318); and that, on the other hand, no serious hazards exist in the construction of a pipe line from producing centers to the Los Angeles district and that it would require many transmission lines to go out before the company would be without a natural gas supply. (R. 345.)[1] Furthermore, anyone of the principal transmission lines would supply more gas than the generators (kept hot for emergencies) could manufacture when considered from point of view of thermal units. (R. 495.)

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(1) Mr. Masser, Vice-President and Ex-Engineer of the Company, stated (R. 345):

"While the various transmission lines throughout the Los Angeles Basin are largely interconnected at the present time, the load requirement in the various districts must be considered in determining the possibility of obtaining gas in Los Angeles."

Accrued Depreciation

Appellant attacks the holding of the Commission and of the court below fixing accrued depreciation at $7,650,000, claiming that such depreciation amounts to only the sum of $3,470,326, a difference of $4,179,674.

In the court below appellant did not apparently attack any particular item but argued, as it argues here, that Commission Engineer Wehe made his estimate of accrued depreciation upon the straight line method "as a mere mathematical computation," and that "it was not intended to represent the accrued depreciation nor was it computed for that purpose." (App. Br., pp. 120-121.)

We take issue with this premise and draw to the court's attention the voluminous evidence of the engineer who testified upon this subject. (R. 288, et seq.) In other words, here again the appellant attacks the finding of the Commission upon the weight of the evidence and a conflict therein. (R. 43.)

As we have heretofore stated, it is not the province of this court to weigh the evidence.[1] The conflict in evidence on this point is plainly apparent. The record shows that company witness Luick personally did not make any substantial physical examination of the property in arriving at his estimate of accrued depreciation of $3,470,326 (R. 386). On the contrary, the record shows that the Company employed several men, two of whom were engineers, to make an examination of different elements of property and compile an estimate of cost to place the property in a 100% operating condition. (R. 381, et seq.) Reports from these men, some of whom appear to be office clerks and others managers of sales organizations,

(1) Akron, Canton & Youngstown Ry. Co. v. U. S., 261 U. S. 184.

were the basis of the Company's findings of accrued depreciation as of January 1, 1930.[1] No opportunity was given to cross-examine the men who were said to have examined the property and compiled estimates on cost to restore. According to company witness Luick, the method followed by the men examining the property and compiling estimates of accrued depreciation was, in effect; if a gas holder was still holding gas with the exception of a few leaks that existed, and was in need, possibly, of a coat of paint, then the only diminution in value from the cost to restore brand new, irrespective of the age of this gas holder, the expired life or the expected life in the future, was the cost only of caulking the leaks and giving it a coat of paint. As another example, if a reciprocating compressor at the time of inspection was in need of having cylinders rebored, then the only difference in value between that and a brand new compressor was the cost of reboring the cylinders, notwithstanding the fact that it is quite possible that one rebore is all this compressor would stand before being scrapped and replaced with a new one. (R. 387.)

(1) Mr. Luick testified (R. 381):

"After receiving such estimates and reports (as to accrued depreciation) I have made personal inspection of SOME of the property to make certain that the estimates used were reasonable." Exhibit No. 35 (R. 381) shows a typical letter to Mr. Luick by one of the Company's assistant engineers, setting up important data of the cost to restore steel gas mains. Regarding this exhibit M Luick testified (R. 385):

"Exhibit No. 35 is a copy of two of the reports made to me by the various men who inspected the items of physical property and also who made the computations which I required on the distribution system."

He further testified (R. 388):

"I have seen some of the foreman's reports on mains but I did not go into the details of such reports. I assumed that they were correctly compiled and have accepted such reports, except that I have substituted other designations of condition for those used by the foreman. I thought that the percentage of condition method was poorly conceived and inaccurately expressed the condition in which the main actually was."

Again, if an automobile was still running or operating, then there existed no difference between the present value of this machine and a brand new one, regardless of how many years it had been in service, with no attempt made to estimate the average active life of such equipment and what portion thereof had already expired. (R. 389.)[1]

The Company witness very definitely states, under cross-examination, that the element of time was of no concern in arriving at the diminution in value of elements of physical property. (R. 387.)

The entire discussion here, however, becomes somewhat academic as the Commission did not make any deduction from the rate bases used either on actual cost or present value on account of accrued depreciation in the property. The evidence becomes important only as relative to the allowance to be made for *annual* depreciation, hereinafter discussed.

Other Capital Items

Appellant complains, under this heading, that the Commission did not allow sufficient sums for working capital, materials and supplies and for 1930 additions. Here again the questions involved were matters of fact based upon conflicting evidence. (See, *Moffat Tunnel Imp. District v. Denver and S. L. Ry. Co., supra,* and *United Fuel Gas Co. v. Railroad Comm., supra,* to the effect that the determination of an administrative commission is con-

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(1) See Commission's comment on Mr. Luick's views on accrued depreciation (R. 42, 43). After referring to the fact that this Exhibit No. 35 "shows that he made no deduction on over 86% of the steel wrough iron mains," the Commission concludes "it is apparent that the application of Mr. Luick's service theory (called by him cost to restore theory) of depreciation gives results which cannot be accepted."

clusive on the courts unless its action is fraudulent or arbitrary.)

II. Revenues

Appellant states that (Br., p. 126):

> "An estimate of future revenue under the reduced rates is made difficult by the fact that the Company's gross and net revenues vary with weather conditions."

The argument is then presented that, because of lower revenues actually received than those estimated, the rate fixed by the Commission is confiscatory. It must be borne in mind, however, that rates are established not only for the present but also for the future and in establishing rates for the future estimates of revenue must be based on normal temperatures.

It must also be remembered that no practical test of rates as prescribed by the Commission has been made, for the reason that the rates have never been put into effect. We contend that before the Company should complain as to what revenues would be produced through the rates prescribed by the order and decision of the Commission, which it is now seeking to enjoin, a practical test should be made by placing the rates into effect over a reasonable period of time. The revenues of the Company from sales of gas may, obviously, for any particular year go up or go down, depending upon temperature fluctuations.

Appellant in its brief states (p. 130):

> "This progressive discrepancy between the estimates and the actual experience of the Company of itself is sufficient to indicate that the question of confiscation should not be decided on the basis of estimates in the face of actual experience."

Applying this rule, rates for the future could never be determined.

In *City of Knoxville v. Knoxville Water Co.*, 212 U. S. 1, this court said:

> "* * * In the course of presenting its case the city offered evidence of the net income of some years subsequent to the passage of the ordinance. The case is peculiar. The Company has never observed the ordinance. The suit was begun nine months after its enactment and tried considerably later. In the meantime the Company's gross income had largely increased. But the decision in the court below was based solely on the operations of the fiscal year ending March 31, 1901, and the amount of net income ascertained, namely, $36,000, was obtained by applying the reductions made by the ordinance to the operations of that fiscal year. We think it was error to confine the investigation to, and base the judgment upon, that year alone. The precise subject of inquiry was, what would be the effect of the ordinance in the future? The operations of the preceding fiscal year, or of any other past fiscal year, were valueless if the year was abnormal, and were only of significance so far as they foretold the future. If, as in this case, sufficient time has passed, so that certainty instead of prophecy can be obtained, the certainty would be preferable to the prophecy. In this case there could be no absolute certainty, because the ordinance had never been put in operation. But evidence of the operations of the years succeeding to the ordinance is relevant and of great importance, and by a consideration of such evidence a much greater degree of certainty could be obtained. Suppose, by way of illustration, that before bringing suit the company had put the ordinance into effect

and had observed it for a number of years, and the result showed that a sufficient net income had been realized, is it possible that a suit then could be brought and the evidence confined to a period prior to the ordinance, and by a process of speculation the conclusion reached that the ordinance would be confiscatory? Some evidence regarding the income of the company, after the passage of the ordinance, is in the record, but it subsequently was excluded from consideration. It showed an increase of gross and net earnings, but also an increase in the property devoted to the public use. We are unable to say what the effect of the evidence excluded would be; all we can say is, that the inquiry was unduly limited by the exclusion of the evidence of the operation of subsequent years.

"If a company of this kind chooses to decline to observe an ordinance of this nature and prefers rather to go into court with the claim that the ordinance is unconstitutional, it must be prepared to show to the satisfaction of the court that the ordinance would necessarily be so confiscatory in its effect as to violate the Constitution of the United States. In Ex parte Young, 209 U. S. 123, the last word of caution by this court was said (p. 106): 'Finally it is objected that the necessary result of upholding this suit in the Circuit Court will be to draw to the lower Federal courts a great flood of litigation of this character, where one Federal judge would have it in his power to enjoin proceedings by state officials to enforce the legislative acts of the State, either by criminal or civil actions. To this it may be answered, in the first place, that no injunction ought to be granted unless in a case reasonably free from doubt. We think such rule is, and will be, followed by all the judges of the Federal courts.'

> The same thought, in effect, was expressed in San Diego Land & Town Co. v. National City, 174 U. S. 739, 754, 'judicial interference should never occur unless the case presents, clearly and beyond all doubt, such a flagrant attack upon the rights of property under the guise of regulations as to compel the court to say that the rates prescribed will necessarily have the effect to deny just compensation for private property taken for the public use.' And in San Diego Land & Town Company v. Jasper, 189 U. S. 439, after repeating with approval this language, it was said (p. 441): 'In a case like this we do not feel bound to reexamine and weigh all the evidence, although we have done so, or to proceed according to our independent opinion as to what were proper rates It is enough if we cannot say that it was impossible for a fairminded board to come to the result which was reached.' "

In the case of *Lincoln Gas Co. v. Lincoln*, 250 U. S. 256, at page 262, the court said:

> "* * * As early as the month of January, 1909, this court, in two notable rate cases, indicated its views of the importance, in any but a very clear case, of subjecting prescribed rates to the test of practical experience before attacking them in the courts. Knoxville v. Knoxville Water Co., 212 U. S. 1, 16-18; Wilcox v. Consolidated Gas Co., 212 U. S. 19, 54. When those decisions were announced this case was pending in the circuit court, and shortly thereafter it was decided adversely to complainant upon the question of the validity of the rate, the Knoxville and Willcox Cases being cited. 182 Fed. Rep. 926, 929. Then, if not before, complainant might have made a practical test of the sufficiency of the rate, instead of waiting six years longer before doing so."

Therefore, we submit that no injunction should issue in this case for the reason that no practical test has been made of the rates, and that as to what revenue would be produced if such rates are put into effect is speculative and not sufficient to warrant this court in directing the court below to issue a permanent injunction.[1]

III. Operating Expenses

Depreciation Annuity

The Company objects to the amount which the Commission allowed as depreciation annuity. On the fair value basis the Commission allowed the sum of $1,072,000 and the Company contends that there should be allowed at least the sum of $2,306,606. (Br., p. 147.) It must be borne in mind that this is a rate proceeding and the end sought is a reasonable return to the Company on the fair value of the property used and useful in the public service.

The Commission in arriving at the amount which it found as just and reasonable to be allowed as a depreciation annuity followed the sinking fund method, using 6% as the basis of calculation, which method, consisting of

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(1) The Commission in its decision stated (R. 25):

"In recent rate cases the Commission has experienced difficulty in fixing rates which yielded the rate of return intended and thought rasonable. Late in 1926 rates were fixed to yield a return of 7.8% (29 C. R. C. 146). They actually yielded in 1927 8.88%, and in 1928 8.83%." (See Table I.)

"Again, late in 1928, the Commission fixed rates to yield a return of 7½% (32 C. R. C. 379). They actually yielded a return of 9.66%."

Furthermore, there is nothing in the record before this court indicating that the Company has put into effect any economies whatsoever due to the depression beginning in 1929 and continuing to date; or being forced to curtail revenues due to the lessened purchasing power of the people. On the other hand, it rather presumptuously asks that the federal courts guarantee it at least an 8% return.

compounding interest thereon at the rate of 6% per annum (being the amount used in this proceeding), will, at the termination of the estimated life of the investment, replace the property.

The Company contends that the depreciation annuity should have been computed by using the straight line method, which consists in calculating from examination and experience in like constructions the total life period of the constituent parts of the plant and then charging to depreciation an annual sum which would be sufficient to replace the property at the end of its useful life, but does not take into consideration interest on that sum which has been set aside as a depreciation reserve.

The Supreme Court of the State of California, in the case of *Pacific Gas & Electric Co. v. Devlin*, 188 Cal. 33, at page 45, said:

> "A distinction may be drawn and has been frequently recognized between a rate-paying appraisement of a public utility and an appraisement of value to determine its worth in condemnation proceedings, in the application of one or the other of these methods of fixing the depreciation.
>
> "In rate-fixing the end sought is a reasonable return to the public utility for its use in the public service. Such reasonable return logically should be upon a basis that will pay a certain profit and replace the property at the end of its life. The sinking fund method is commonly used in such connection. * * *."

The Company claims a total accrued depreciation amounting to the sum of $3,470,326; that is, that the total amount of depreciation which has accrued to the entire property of the Company from the time it has

first been placed in service to the date of inquiry amounts to the sum herein set forth. It claims that it should be allowed to charge to depreciation annually the sum of $2,830,487. To us this demonstrates the absurdity of the Company's contention. If the property of the Company depreciated at the rate of $2,830,487 annually, the accrued depreciation should be far in excess of $3,470,326. If the sum of $3,470,326 is the correct amount for accrued depreciation, then the Company should not be allowed to set aside annually the exorbitant sum of $2,830,487 as a depreciation annuity.

We have heretofore shown the methods used by company witness Luick in determining accrued depreciation, which methods the Commission refused to accept. As we are concerned here primarily with results and not with methods, we may summarize the findings of the Commission, which the lower court sustained, as follows:

1. The Commission calculated depreciation expense on present value and not upon historical cost. (R. 47.)

2. The Commission did not accept the Company's evidence presented by Mr. Luick that an annual allowance of $1,300,000 should be made to the depreciation reserve and that said amount was merely a contingency fund to safeguard the Company against possibilities that cannot be foreseen, as it was not based upon any study of the Company's actual needs.

3. The Commission accepted a longer life for the Company's property, upon the testimony produced by commission witness Wehe, than that claimed by company witness Luick. This was purely a question of fact.

4. The Commission pointed out it made no difference which method (sinking fund or straight line) was used

in computing depreciation annuity, provided one or the other is used consistently. The Commission's engineer (Wehe) determined the accrued depreciation on both straight line and sinking fund bases.

If the amount of $2,830,487 claimed by appellant for depreciation annuity on a straight line basis is correct, then the rate base must be depreciated accordingly.

5. The accumulated depreciation reserve was, on December 31, 1929, $9,350,689 (R. 165). Appellant contends that there should be added to this reserve not less than $1,300,000 annually, although it is admitted that if the estimate for actual accrued depreciation be deducted, which Judge Wilbur held the evidence indicates was not to exceed $482,469 (R. 169), the balance would be held as a mere contingency fund to meet contingencies "which cannot be reasonably anticipated." As Judge Wilbur found in his concurring opinion (R. 169), "we find no basis in the law for the allowance of such a reserve aside from those cases which hold that a company is entitled to accumulate some little surplus as a part of its financial set-up. Such a surplus has been and is being allowed to the Company."

We submit that in view of the fact that approximately $11,000,000 of property was left in the rate base by the Commission, which should have been excluded as non-operative, which property was represented by the gas manufacturing plants, and which item alone represents $464,331 of depreciation annuity (R. 170), the amount fixed by the Commission, in the sum of $1,072,000, was liberal and just. We also desire to point out again that the depreciation studies presented by commission witness Wehe and company witness Luick were highly conflict-

ing, and the final results found were based upon so many matters of fact that it is not within the province of this court to determine what such a depreciation annuity should be. Judge Wilbur, in the court below, found as a fact (R. 170) "that the depreciation annuity fixed by the Railroad Commission, $1,072,000, is sufficiently accurate as an estimate for depreciation to be deducted from the gross revenues in the determination of the question as to whether or not there has been a confiscation of the plaintiff's property." We submit that this finding, upon the weight of the evidence and the conflict therein, is binding upon this court and not reviewable here as a question of fact; we also contend that the showing made by appellant under this head shows no confiscation whatsoever.

IV. Rate of Return

The return the Company will make is necessarily dependent upon the present fair value of the Company's property used and useful in the service of the public; the gross and net revenues and operating expense allowed which when properly computed will give the rate of return.

The Commission in its decision set up various tables showing these different factors, and in Table IV (R. 45) it shows the rate of return which the Company experienced on a fair value basis for the years 1928, 1929 and 1930 of 8.3%, 9.4% and 8.8%, respectively, or a weighted average return for the three-year period of 8.9%. After deducting the approximate 9% in gross revenue, ordered by the Commission, Table V (R. 47) shows that the weighted average return for the same three-year period

would have been—on the historical basis, 7.8%, and, on the fair value basis, 7.1%.

As we have heretofore stated, the Commission's experience has been that the rates fixed in prior years actually yielded more.[1] So, upon the actual experience of the Commission in the fixing of rates for public utilities, the actual return to the Company can safely be said to exceed the rates fixed under the reduction of 9% by over 1%. This no doubt would result from economies which could be put into effect by the Company.

As we also stated before, there is nothing in this record indicating that the Company has lowered salaries or put into effect such economies as businesses all over the United States, since the depression started in 1929, have been compelled to do. On the other hand, it can safely be said that the Company is now profiting, and has profited since 1929, in the greatly decreased cost of labor and material. Appellant, however, alleges in its brief (p. 166):

> "When courts sustain an 8% return to gas companies located in the City of New York, it would seem self-evident that a rate of return even higher than 8% should be allowed companies operating in Southern California and engaged in the distribution of natural gas."

With this we do not agree, for the reason that the Company here enjoys an absolute monopoly of the business. In Eastern centers the gas business is much more hazardous, due to the fact that substitute fuels are available; there is greater trouble and expense in procuring franchises; there are competing gas companies in the

(1) See page 37.

field; larger expenditures of capital are required before the business becomes a paying one; and many other factors existent which are not found in this locality at all. Here, for example, as we have referred to, the Company procures its natural gas from many fields, over many lines, and an adequate supply of such natural gas is available for many years to come. (R. 312).

It was in evidence that in 1930 the producing oil companies were blowing off into the air daily more natural gas than could be marketed. (R. 307).[1]

It was in evidence that this gas costs the Company 15½c to 17½c per m.c.f. delivered to its system. (R. 357). The average householder paid, under the rates prescribed before the hearing, approximately 87½c per m.c.f.[2]

It is also apparent by a minor mathematical computation that the Company's gross profit on the sale of this gas exceeds 400%. All the Company has to do to make this huge profit is to receive the natural gas into its system, pump it through its mains to the consumer and collect its bills.

The Company is also in a most favorable position in

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(1) Prof. Dodge, a witness for the City, testified:
"For the month of May, 1930, there was a net gas production in the State of California in the amount of 1,500,000 m.c.f. per day, of which 344,000 m.c.f., or 23%, was taken by gas companies and others for resale and 700,000 m.c.f., or 46%, was blown into the air for lack of market or storage facilities."
He also testified (R. 306):
"Thirty-six fields in the State of California produce gas in commercial quantities, all of which can readily be connected with the transmission lines bringing gas into the Los Angeles area. But not all of these fields are expected to yield gas for any substantial period of time."

(2) This is computed upon Schedule No. 1 (R. 4). 80c for the first 300 cu. ft., or less, per meter; and for all over 72½c per m.c.f. To the householder consuming 4000 cu. ft. the rate would approximate 87c per m.c.f.—300 ft. at 80c; 3700. at 72½c; 4000 ft. for $3.48—or 87c plus per m.c.f.

that: (1) it is secure against competition; (2) there are no practical substitute fuels for domestic use (R. 417); (3) the demand for gas is constantly increasing (R. 417);[1] (4) the district is rapidly growing—in fact, its growth is one of the most unprecedented in the history of the world;[2] (5) there is nothing in the record indicating that the Company has any difficulty whatsoever in procuring credit—in fact, the evidence shows as a whole that the Company's bonds and stocks are considered a very safe investment. In this connection, attention is directed to the fact that in the year 1929—$21,800 of its 6% preferred stock was sold at an average price of $105.22 per share, or at an effective dividend rate of 5.70% (R. 238), and that the effective interest rate on money realized from the sale of bonds was 5.34% in 1927, when the Company made its last issue of 5% bonds. (R. 236). If this is considered in connection with the statement of Mr. Justice Brandeis in the *Galveston* case, 258 U. S. 388, that the courts will take judicial notice of the fact that current rates of return on capital are much lower than they were during the wartime period, we can state with assurance that the Company could now be financed at a much lower rate.[3]

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(1) Mr. Day, President of the Company, testified as follows (R. 417): "Since natural gas has become available the business has grown very largely and at present practically all domestic cooking, water heating and house heating is done with gas. Many buildings, including hospitals, are constructed without provision for the use of any other kind of fuel and without brick chimneys so that a shortage now would be extremely serious."

(2) See page 190 of appellant's brief, footnote (1), where appellant shows population of Los Angeles in 1910, 319,198, and connected meters of the company 71,967; which had increased in 1930 to 1,238,048 population and connected meters 355,468.

(3) In the Galveston case Mr. Justice Brandeis stated:
"We know judicially that the period (since the world war) has, in general, been one of continuous price recession and that the current rates of return on capital are much lower than they then were."

Appellant sets forth ten hazards of the Company's business (p. 166 of its brief). We will take these in order with our comment thereon:

1. Temporary and permanent interruption of the supply of natural gas. The Commission conclusively found otherwise (R. 49).

2. Competition with other fuel. There is nothing in the record showing any substantial competition with other fuel in the domestic consumption of gas, save electricity on a very small scale—in fact, Mr. Day, the President of the Company, testified at length as to the necessity of the standby plant to insure the Company's service of gas (R. 418). There are small amounts of wood and coal used in the district but these are negligible.

3. Possibility of municipal competition. This could only come about through condemnation of the Company's system. There is nothing in the record indicating any such possibility.

4. Extreme variations in sales due to fluctuations in temperature. This is purely an engineering problem, and has been successfully handled by the Company in the past.[1]

5. Increased cost trends of natural and artificial gas. This is quite probable; however, is not a hazard of the business but merely one of increased cost of production.

6. Lag between necessity for and effectiveness of increase in selling rates. This also is merely a question of

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(1) Samuel Crowther, in an article entitled, "Lessons of the Depression," in Public Utilities Fortnightly, dated Jan. 5, 1933, states: "The elemental services of all the utilities are very simple. The mass production of their services has none of the style problems of industry and the mass distribution of these services presents very few difficulties in comparison with the merchandising of other products. **THE BASIC PROBLEMS HAVE LARGELY TO DO WITH ENGINEERING AND FINANCE.**"

adjustment of rates with the Railroad Commission due to increased cost of production, maintenance or operation; it works both ways.

7. Necessity of providing new capital when needed, irrespective of condition of money market. As we have previously remarked, the record here shows the last bonds sold by the Company were at an effective rate of 5.34%. (R. 236). The last issue of its preferred stock was at an effective dividend rate of 5.70% (R. 238). Its common stock earned, in 1929, 23.33% and dividends of 17% were paid (R. 233). The common stock is entirely owned by the holding company, Pacific Lighting Corporation, and amounts to $20,000,000. $5,500,000 of the common stock was issued as stock dividends (R. 233), and, according to Commission witness Frankhauser, "the average historical cost of the Company's bond, stock and depreciation reserve money is 6.15%." (R. 233.) As the Company is now more stabilized than it was in prior years, and as interest rates have been greatly reduced since the termination of the world war this hazard is negligible for some years to come.

8. Industrial shift. If by this is meant the shift by industries from gas to other fuels, we will admit that such shifts do occur, but as the industrial business of the Company is negligible we do not consider any real hazard exists on this ground.

9. General obsolescence. Theoretically and practically this hazard is protected by the depreciation reserve.

10. Earthquake, fire and similar hazards. These hazards are insured against and are also protected by the depreciation reserve.

The appellant sets up an additional hazard allegedly caused by the Commission's policy and practice of fixing rates. When the Commission's finding here is that the Company has been enjoying a weighted average return, historically, for 1928, 1929, and 1930, of 9.7% (R. 26), and as the reduction in rates has been enjoined, it is difficult to see how the Commission's regulation becomes a hazard. In fact, the Commission's regulation, together with the due process clause protection of the state and federal constitutions, would seem the greatest safeguard possible to guarantee a public utility a return not enjoyed by any other businesses. This is particularly true at this time when most businesses are struggling to make any return whatsoever.

7% Return Is Not Confiscatory

Under the rulings of this court, the only question involved is whether or not the return to the Company is confiscatory;[1] not whether said return should be greater or less.

Prior to the world war a net return to a public utility company of approximately 6% was considered ample by this court, as the following cases indicate:

Knoxville v. Knoxville Water Co. (1909), 212 U. S. 1 (4% not necessarily confiscatory);
Wilcox v. Consolidated Gas Co. (1909), 212 U. S. 19 (6% a fair return);
Cedar Rapids Gaslight Co. v. Cedar Rapids (1912), 223 U. S. 655 (6% a fair return);
Des Moines Gas Co. v. Des Moines (1915), 238 U. S. 153 (6% not confiscatory).

(1) Knoxville v. Water Co., 212 U. S. 1; Darnell v. Edwards, 244 U. S. 564; Lincoln Gas & E. Co. v. Lincoln, 250 U. S. 262; Galveston Elec. Co. v. Galveston, 258 U. S. 402.

Immediately after and during the world war, due to increased cost of all commodities, rates of return were increased somewhat by this court, as the following cases indicate:

Lincoln G. & E. L. Co. v. Lincoln (1919), 250 U. S. 256 (this court declined to approve a finding that no rate yielding as much as 6% was confiscatory);
Galveston Electric Co. v. Galveston (1922), 258 U. S. 388 (8% not confiscatory);
S. W. Bell Teleph. Co. v. Pub. Serv. Corp. (1923), 262 U. S. 276 (5-1/3% wholly inadequate, Justices Brandeis and Holmes partially dissenting);
Bluefield W. W. & I. Co. v. Pub. Serv. Comm. (1923), 262 U. S. 679 (6% too low);
McCardle v. Indianapolis Water Co. (1926), 272 U. S. 400 (reasonable rate of return not less than 7%, Justices Brandeis and Stone dissenting);
United R. & E. Co. v. West (1930), 280 U. S. 234, (6.26% inadequate, Justices Brandeis, Holmes and Stone dissenting).

The kind of utility involved must also be taken into consideration. Street railway systems' profits have been seriously menaced by the general use of the automobile, which is, in fact, a most serious hazard to transportation companies' businesses everywhere, possibly necessitating a larger return because of the greater hazard of the business.

So, also, in the *West* case cited by appellant (280 U. S. 234), the utility was operating a street railway company, where it was in evidence that while the total number of passengers carried had for sometime steadily decreased, the number carried during the rush hours had increased, resulting in an increase of expenses in proportion to the

whole number of passengers carried; and that, furthermore, the company was unable to borrow money at a low rate of interest.

As was said by the Supreme Court of Iowa in the *Cedar Rapids* case (144 Iowa 426, 120 N. W. 966):

> "What compensation will be reasonable is a question of fact to be determined in the light of the evidence in each particular case. No court of last resort has undertaken to say what percent on the value such an investment should yield its owners in all cases."

And as Mr. Justice Peckham said in the *Consolidated Gas Company* case of New York, 212 U. S. 19 (a leading case on the subject) (at p. 48):

> "There is no particular rate of compensation which must in all cases and in all parts of the country be regarded as sufficient for capital invested in business enterprises. Such compensation must depend greatly upon circumstances and locality; among other things the amount of risk in the business is a most important factor, as well as the locality where the business is conducted, and the rate expected and usually realized there upon investments of a somewhat similar nature with regard to the risk attending them. There may be other matters which in some cases might also be properly taken into account in determining the rate which an investor might properly expect or hope to receive, and which he would be entitled to without legislative interference. The less risk, the less right to any unusual returns upon the investments. One who invests his money in a business of a somewhat hazardous character is very properly held to have the right to a larger return

without legislative interference than can be obtained from an investment in government bonds or other perfectly safe security. The man that invested in gas stock in 1823 had a right to look for and obtain, if possible, a much greater rate upon his investment than he who invested in such property in the city of New York years after the risk and danger involved had been almost entirely eliminated.

"In an investment in a gas company, such as complainant's, the risk is reduced almost to a minimum. It is a corporation, which, in fact, as the court below remarks, monopolizes the gas service of the largest city in America, and is secure against competition under the circumstances in which it is placed, because it is a proposition almost unthinkable that the city of New York would, for purposes of making competition, permit the streets of the city to be again torn up in order to allow the mains of another company to be laid all through them to supply gas which the present company can adequately supply. And, so far as it is given us to look into the future, it seems as certain as anything of such a nature can be that the demand for gas will increase, and, at the reduced price, increase to a considerable extent. An interest in such a business is as near a safe and secure investment as can be imagined with regard to any private manufacturing business, although it is recognized at the same time that there is a possible element of risk, even in such a business. The court below regarded it as the most favorably situated gas business in America, and added that all gas business is inherently subject to many of the vicissitudes of manufacturing. Under the circumstances, the court held that a rate which would permit a return of six per cent would be enough to avoid the charge of confiscation, and for the reason that a return of such

> an amount was the return ordinarily sought and obtained on investments of that degree of safety in the city of New York."

We think the business of the Company in the Los Angeles district closely parallels the conditions spoken of in New York City in these particulars. The record before this court indicates: (a) that the Company has been making returns in the past three years prior to the effective date of this order averaging nearly 9%; (b) that it has practically an absolute monopoly of the gas business in the territory served; (c) that it is secure against competition under the circumstances in which it is placed; (d) that there are no practical substitute fuels; (e) that the demand for gas is constantly increasing; (f) that the district is rapidly growing, in fact, its growth is one of the most unprecedented in the history of the world; (g) that the Company has no difficulty whatsoever in procuring credit at a relatively low rate of interest and the rate has constantly decreased since 1921 (R. 238), has continued to decrease since the effective date of the Commission's order, and will tend to decrease in the immediate future; (h) that the earnings on its common stock have increased from 7.25% in 1912 to 23.33% in 1929 (R. 233), and this notwithstanding the fact that the common stock includes $5,500,000 issued as stock dividends and the balance of $14,500,000 was authorized upon the theory that prior earnings of the Company had been invested in company properties and not distributed and the issuance was not based upon actual sales for a money consideration, as the stock is entirely owned by the Pacific Lighting Corporation and has never been traded on any exchange (R. 239).

Surely, under all the facts, a reduction of only 9%, such as the Commission here made, does not bring about a confiscatory return; on the contrary, we submit that because of the facts and due to the favorable position in which the Company finds itself, in that the Company has large supplies of natural gas at its very door upon which it makes a gross profit of 400%, the Commission could, in all reason, have reduced rates materially more.[1]

V. Gas Manufacturing Plants

Appellant states there is no specific finding, either by the Commission or the court below, that the manufacturing plants of the Company are not used or useful in the service of the Public (Br., p. 189). With this we take issue. Both the Commission and the court below held, in effect, that the gas plants were *not* used and useful in the public service but the Commission nevertheless erroneously, we think, included them in the rate base, evidently upon the historical cost theory of prudent investment, which the Commission also seemed to believe would necessitate amortization if stricken from the base. (R. 33.) We say this does not follow in the fixing of present fair value. In an historical consideration of such property, if the plants are eliminated as "operative" property, it would follow, as the Commission points out (R. 49), that "provision would be made for the amortization of the money invested in them." Considered, however, from the point of view of "reproduction cost new"

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(1) It is also significant that, as the Commission points out in its decision (R. 22), "the Company's surplus has grown from $381,212.97 in 1916, to $4,176,663.09 in 1929, while its depreciation reserve increased from $3,804,383.36 to, as said above, $16,804,-105.15."

and "present fair value," a different situation is presented, which the Commission also points out. (R. 49.) Under the theoretical "reproduction cost new" it cannot be said that with "the existence of a natural gas supply adequate for years to come," which the Commission stated "the evidence convincingly and satisfactorily establishes" (R. 49), prudent investment would require the Company to construct standby plants of this character, or at all. As we have heretofore pointed out, the present plants are inadequate to supply the peak demands of the Company in the wintertime; the gas would not burn without adjustment of the consumers' appliances; and by the time the plants were put upon any production basis, temporary repairs could be made in the transmission lines wherever needed and with the network of transmission lines bringing natural gas into the Company's system, it is most questionable if the breaking of any particular line or lines would be of any effect whatsoever. It should also be remembered that the evidence before the Commission showed that no material amounts of gas have been produced in the plants since 1927. (R. 317, 343, 344, 495.) The Company had invested in these plants approximately $11,627,911 (R. 496) upon the present fair value basis. It was also in evidence that if these plants were eliminated from the rate base reduction in operating expenses was estimated from $482,255 to $528,-226, depending upon the overheads used and upon whether historical or reproduction cost new bases were used. (R. 315.) We therefore say that the Commission, in stating that "the evidence, under all the circumstances, did not justify their retirement and amortization at this time" (R. 49), was at least most liberal to the Company

and that the inclusion of this large item (about $11,000,000) would decisively prevent any confiscatory rate.

As the concurring opinion of Mr. Justice Wilbur, in the court below, states (R. 152-153):

> "For instance, if it appears from the record that the Commission has included in its rate base $10,917,727 of worthless property upon which the Company is not entitled to income and has erroneously excluded a like amount upon which the Company is entitled to an income (such as going concern value, etc.), we could not hold that the rate was confiscatory because the rate base was too small. On the contrary, the rate base would be exactly correct. * * * We are, however, only concerned with the question of confiscation, and if we can say that the rate fixed is not unreasonable, having due consideration for the factors involved including the admitted partial, if not total, obsolescence of the manufacturing plant, it will be unnecessary to attempt the solution of the problem which has been considered doubtful by the Commission and been avoided by the parties other than the intervening cities of Los Angeles and Pasadena."

We say, therefore, that the manufacturing plants are not used and useful in the public service, and both the Commission and the court below, in effect, so found.[1]

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(1) A great portion of appellant's brief under this heading is outside of the record and should not be considered in any way by this court. Thus for instance, there are many references to California Railroad Commission Reports, which appellant seeks to use in an EVIDENTIARY WAY, although never introduced in evidence before the Commission nor in the court below. This occurs on pp. 194, 196, 197, 204 and 205 of its brief.

The rule has always been that courts will not take judicial notice as a matter of evidence of decisions of administrative tribunals such as California Railroad Commission. If decisions of these administrative bodies are sought to be relied upon as matters of

Conclusion

We think careful analysis of the decision of the Commission shows full consideration of all the rights of the Company, and that the 9% reduction in rates is not sufficient to justify injunctive relief upon the ground of confiscation, which is the only ground the Company can urge here.

We feel that the Commission properly arrived at "present fair value," giving careful consideration to historical cost and reproduction cost new; that under the doctrine of *Smyth v. Ames*, and the decisions of the United States Supreme Court since, all the factors necessary in arriving at a proper rate were carefully considered, and the results attained were fair, just and equitable to the Company. As we have pointed out, much of the evidence before the Commission was conflicting, and, under the authorities, we think, without question, the Commission's findings on such matters are final and conclusive, unless arbitrary or fraudulent. We do not feel that appellant has in any way shown the action of the Commission in any particular to be arbitrary or fraudulent.

The Company in former years has been making a large return for a public utility corporation, as shown

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evidence they must be pleaded and proved. (Mound Water Co. v. So. Cal. Edison Co., 184 Cal. 602.)

Likewise, appellant, on p. 198 of its brief, goes entirely outside the record in bringing in as matters of evidence experiments as to the practicability of manufacturing gas from Diesel oil having a heat content approximately equal to that of natural gas, so that a mixture can be formed which can safely and properly be burned in the consumers' equipment without adjustment.

So, also, on p. 200 of its brief, appellant quotes, as a matter of evidence, an alleged statement made by Mr. Brown, the Commission's gas engineer, to the effect that "no relation exists between the production of, and demand for, natural gas." No opportunity of cross-examination was given to the opposing parties on these matters so, obviously, this court cannot consider them in any evidentiary way whatsoever.

by the record. In the year 1930 it was confronted with a business depression and abnormally high temperatures. These two factors have naturally reduced the gross earnings of the Company, but we maintain that rates should not be fixed upon the Company's actual experience for any one year. Conversely, the earnings of the Company for the year 1930 might have been abnormally high, and it surely could not be argued that because of that fact the Commission should fix rates *in the future* upon that basis; yet, in effect, that is the position the Company takes before this court. It might also be said that the value of the Company's plant without consumers would be worth nothing. How, then, as an abstract proposition, can the Commission fix present fair value otherwise than upon consideration of what the Company actually spent for the property; and what its reproduction cost less depreciation, if any, would be, using price levels for the latter valuation that are fair and reasonable? We say that this is precisely what the Commission did do and that it would be unreasonable to permit the Company to build up theoretical values of nearly $33,500,000 for intangibles, a sum which the Commission said equaled "more than 50% of the claimed direct replacement cost of the physical property." (R. 37.)

Again, we say, the Company is unfair in its argument as to depreciation. As appears from the record, it claims that it should be allowed annual depreciation of $2,830,487; yet accrued depreciation, it says, does not exceed $3,470,326.

When it is considered that annual depreciation is charged to operation and paid for by the consumer, and accrued depreciation is taken out of the Company's rate

base, the unreasonableness of these claims is the more apparent.

We feel that, under all the circumstances, the decree of the court below should be affirmed.

Respectfully submitted,

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